

**Research
Bulletin**

No. 187

The Conference Board**Foreign Competition
and U.S. Trade Policies****Executive Views and Company Activities***by Seymour Lusterman***Management Summary**

- Three factors account for most of the difficulties encountered recently by 295 surveyed United States firms in meeting foreign competition, domestically and overseas—the high dollar, lower foreign costs, and foreign government support to national industries.
- Responses to the new foreign competition have typically included marketing, investment, and legal measures, as well as public-affairs efforts.
- All but a few large firms say that trade issues have grown in importance to their business interests during recent years, and more than three out of five have sought to influence U.S. trade policies.
- Protectionist steps are urged by 38 percent, and government subsidies, loans or tax benefits by 44 percent. Nearly two-thirds ask for one or both of these measures.
- Seven participants in ten expect trade issues to become more important to their companies in the years just ahead than they are today.

CORPORATE RELATIONS PROGRAM

This report is based on responses by 295 major United States corporations, 95 percent of them manufacturing companies, to a Conference Board survey, conducted by mail from late July through early October, 1985. It examines the experience of these firms in meeting foreign competition during the past five years, the efforts they are devoting to trade-policy issues, their views about the role of the government, and their thoughts about the future. Survey responses were chiefly from CEO's and public-affairs executives.

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I. Recent Developments and Their Effects

Beset in recent years by greatly intensified foreign competition—both in their domestic and overseas markets—all but a handful of the surveyed companies have come to regard foreign trade as a major public policy issue. A quarter of the participants now rate it as their top issue, another half as of more-than-average importance.

Competing in the U.S. Market

Difficulties experienced during the last five years in competing profitably and effectively against foreign competition in the United States are attributed principally to three of a number of factors listed in the Board's questionnaire.

Value of the dollar: The greatest proportion—77 percent—say that harm has come to their companies from the high value of the dollar. Most rate the harm as "considerable." A metal products fabricator serves as an example: "Until the dollar began its climb, we had no foreign competition. Today we have been forced to give up some of our markets and products lines. We can no longer compete profitably." At least half the members of every major industrial group report that business has been hurt considerably by the high dollar.¹

Foreign governments' support to their national industries: Seven in ten respondents report that their companies' U.S. businesses have been harmed—considerably in most cases—by imports from firms enjoying special support from their governments. Crucial advantages are said to be gained by foreign competitors from subsidies, tax incentives, low-interest loans, export credits, capital grants, and research and development programs—measures often tied to national economic-development goals. It is also noted that state-owned or controlled businesses often compete, in one participant's words, "without regard for market forces."

Sizable numbers of participants—in most cases, half or more—from the following industry groups say they have been "considerably harmed" by foreign governments' subsidization of national industries: food; textiles; oil and petroleum refining; leather; stone, clay and glass products; primary metals; fabricated metals; machinery manufacture; transportation equipment.

¹Companies are grouped according to their two-digit Standard Industrial Classifications (SIC(s)). The six most commonly-represented groups, comprising 154 firms (52 percent of the total), are: machinery manufacturers (47 firms); electrical machinery and equipment manufacturers (34); fabricated metal products manufacturers (19); primary metal industries (18); instruments manufacturers (18); food and kindred products manufacturers (18). All other manufacturing groups and most non-manufacturing are represented by one or more firms.

Lower foreign costs: Seven in ten participants also say their companies have been harmed by imports from countries with lower labor, materials or other costs, than those in the United States. Contributing to their competitive disadvantage, some note, are costs borne uniquely by U.S. firms for a variety of social ends—from social security to environmental protection. "Superfund taxes alone give nearly a \$7-a-ton cost advantage to the foreign producers of one of our major products," a chemical company executive comments. Virtually all industry groups are represented in substantial numbers among those citing this problem. Included are all of those harmed by foreign governments' support to national industries, as well as makers of furniture, leather and rubber products, electric machinery, and electronic equipment and instruments.

Other factors were mentioned by smaller proportions of respondents.

Actions by the U.S. Government: One-third of the participants say their companies have been harmed in greater or lesser measure by changes in United States tariffs or import quotas, by the government's administration of trade matters, by its tax policies, or by its export programs. Speaking for an instruments manufacturer, one comments, for example: "'Operation Exodus,' and efforts to curb high-tech exports through unilateral controls and restrictive interpretations of export regulations, have created barriers to effective competition in many foreign markets. Bureaucratic delays have often put United States companies in the position of not being able to respond to inquiries or potential orders, while foreign firms are not so encumbered."

Some complain, too, of inaction by the government, most often of a failure to enforce existing trade agreements and to do anything about acknowledged dumping. A much smaller group reports having been benefited by U.S. actions, though most say these have had little or no effect.

Product changes: Foreign products of improved quality, design or technological sophistication have been harmful to the business of about one in six companies, participants say. But a larger group, one in four, reports that the product improvement—and, thus, the competitive gain—has been on its part.

Overall. . .

- 52 percent of respondents say their firms have been harmed—considerably in most cases—by one or more of the developments noted above and have benefited by none of them;
- 37 percent have been harmed by one or more developments, but have benefited by others. The harm appears greater than

the benefit in most cases, however. Typically, it has multiple sources and is judged to be considerable in degree. Benefits usually derive from a single development—most often, improvement in the quality or design of company products—and are much more likely to be described as “moderate.”

- 4 percent report that the only effects of recent developments have been beneficial;
- 7 percent say that none of the developments has had more than slight effects, if any, on their ability to compete profitably and effectively.

Competing in Foreign Markets

The kinds of developments that have acted powerfully on domestic markets have been felt in much the same ways overseas, according to the four out of five participants whose firms do business outside of the United States. The high value of the dollar is the most frequently mentioned source of competitive disadvantage in this area also: 68 percent say it has harmed their firms “considerably.” Subsidies and other forms of government support to national firms, as well as pressures from countries with lower labor, material and other costs, are also cited frequently.

Insofar as export support and promotion programs of the U.S. government have changed during the past five years, the effect has been harmful to more of the surveyed companies than have benefited, according to participants—19 percent versus 4 percent.

Nationalities of Competing Foreign Firms

Japan is mentioned by respondents far more often than any other country as the national home of their major foreign competitors—both in United States markets and overseas. Western European countries as a group, however, are identified by a much larger number. Taken together, the newly industrializing countries (NIC's)—South Korea, Taiwan, Brazil, Mexico, Hong Kong, and Singapore—also outrank Japan, though only in domestic market competition.

Nationalities of chief U.S. competitors	In U.S. markets	In foreign markets
Western Europe	62%	76%
NIC's	59	24
Japan	44	43
Other	15	5

Whether harmed greatly by them or not, participants list the

nationalities of their chief competitors in much the same order and frequency.

Multiple Factors

Many participants note that recent developments have worked in tandem against company interests. For example:

A steel company: “Over the past five years, steel markets outside the United States have become more and more closed, leaving the U.S. market the only major market in the world still open. This change, combined with subsidization of overseas producers and the high value of the dollar, caused imports to increase steadily. At the same time, the currency imbalance created massive imports of steel-intensive products, particularly capital goods. Since the manufacture of capital goods represents approximately 70 percent of steel consumption in the United States, this greatly depressed the purchase of steel by our primary customers.”

A brewer: “The very high dollar has caused long-standing problems of tariff barriers and protectionism to assume an inordinately high profile. As a result of this combination of factors, our products have been unable to compete effectively overseas—and have been forced to withdraw completely from some countries. The problem abroad is contrasted in the United States, where our products now face heightened competition from imports that benefit both from their weak currencies and a negligible beer tariff. As a result we now, selectively, seek reciprocal treatment: We do not appreciate prohibitive tariffs—or even blanket prohibition of entry—from countries we permit to compete here openly and without any barrier, tariff or otherwise.”

An oil company: “Over the last three years, imports of gasoline have tripled. Gasoline is the bread-and-butter product of the U.S. refining industry. Foreign refiners have two advantages over U.S. refiners. For the most part, they don't have the added cost forced on U.S. refiners by environmental, tax, health and safety, and transportation laws (e.g., lead phasedown, OSHA regulations, and other requirements). Also, foreign refiners have access to state-owned crude oil. Middle East refiners, for example, keep the world price of crude oil on the international market artificially high, while they transfer this raw material at little or no cost to their own refining divisions. These products would logically go to closer markets, like Japan and Europe, but trade barriers in those countries all but eliminate petroleum-product imports. Consequently, these products are shipped to the United States at whatever prices the market will bear. Often, the finished products sell for less than the crude oil.”

II. Responsive Strategies

Prominent among the strategies U.S. firms have adopted in response to the greatly intensified foreign competition of recent years are efforts to influence the trade policies of governments and quasi-governmental bodies—most commonly those of the United States, but, among some firms, of foreign

nations—and of such international entities as the European Community and the General Agreement on Tariffs and Trade (GATT).

As shown below, other strategies have also been widely pursued during the past five years.

Percent of Surveyed Firms Pursuing Strategy for Each Target Area

	<i>The United States</i>	<i>Foreign Markets</i>	<i>Either or Both</i>
<i>Marketing Strategies</i>			
Reduce prices for company products to meet foreign competition	55%	41%	72%
Modify or change company products to enhance their marketability relative to foreign products	38	35	53
Increase or otherwise change advertising, promotional or other marketing efforts to meet foreign competition	28	18	37
Other marketing strategies	5	5	8
<i>Investment Strategy</i>			
Initiate operations, or enter joint ventures, outside the United States in order to gain entry into markets or become more competitive	22	48	59
<i>Other strategies</i>			
Increase imports of component parts for assembly in United States	37	10	39
Initiate legal proceedings in the International Trade Commission to stop dumping or other unlawful practices by trading partners	15	4	19
Ask the U.S. government to initiate proceedings in the GATT for rulings on unfair trade policies	14	4	17
Initiate or increase barter or countertrade agreements	2	12	14
Other	7	4	10

III. Trade Policy Activities and Concerns

Almost three out of four (72 percent) of all surveyed firms—and an even higher proportion of the largest ones—have sought to influence the trade policies, directions or priorities of the U.S. government during the past five years. Their efforts have taken various forms, but in most cases have been pursued collaboratively. Thus, nearly two-thirds report participation by company personnel in trade-related policymaking, planning or lobbying activities of trade associations and other business groups. About two in five say the firm has been represented on advisory bodies to government agencies or legislative groups dealing with trade matters. A like number have engaged directly in lobbying. Other, less common, means of trade-policy advocacy include advertising—reported by 7 percent of participants.

If the largest firms are found in disproportionate numbers among companies trying to influence U.S. policy, it is among the smallest ones that concern over trade issues has risen most widely in recent years.

<i>Report that U.S. trade policy</i>	<i>1984 Sales</i>		
	<i>Less than \$100 million</i>	<i>\$100 to \$999 million</i>	<i>\$1 billion or more</i>
Has increased considerably as a company concern	59%	51%	47%
Has become the company's top public-policy concern	31	23	17

IV. Positions on Trade Policy

The public-policy measure most widely advocated—by 69 percent of respondents—is government action designed to lower the value of the dollar. Almost as many favor efforts by the United States to negotiate bilateral and multilateral agreements aiming at eliminating or reducing trade barriers.

But some of these same respondents join others in advocating protectionist measures as well. Often arguing that only the United States plays by the rules of free trade, nearly two out of five (38 percent) of those surveyed want higher tariffs or reduced import quotas to protect companies like theirs against foreign competition. Most say they previously advocated free trade and have come to this position only within the past five years.

A few hedge their new protectionist views with qualifications—as a step to be taken only if last-ditch efforts at negotiated agreement fails—or stress other approaches. A machinery company executive, who says he now favors protectionist measures comments, for example: “We are encouraged by increasing evidences of recognition that there are middle and fair grounds between the extremes of free trade and protectionism. While generally not favoring government intervention in business, we feel that the U.S. government must do much more to help strengthen the competitiveness of U.S. business in world markets; to help open overseas markets to U.S. products; and, through negotiations with other governments, to assist as partners with American business in the sale of U.S. products in world markets.”

Government subsidies, tax benefits or loans are advocated by 44 percent of participants. Including those calling for both protection and other government support, nearly two-thirds advocate further government intervention on behalf of U.S. companies.

Most of those who want such help from the government would also extend it to firms in industries other than their own. Many want protection for auto makers or other industries that employ large numbers of workers. Another sizable group wants such help for “heavy,” “basic” or “capital goods” industries—some mention steel firms—and for companies essential to national defense. “The United States must keep its manufacturing base,” a high-tech company executive says. Some would protect any domestic manufacturer that faces subsidized foreign competition. Others ask the same for firms in the electronics, computer, semiconductor or “high-tech” field. Specific industries—notably textiles, furniture, paper, shoes, chemicals, agriculture and refining—are singled out by one or two participants who themselves represent other types of companies. A very small number—nine of the 295 firms in the study—would provide protection only for other kinds of companies than theirs.

Variations in Protectionist Views

Protectionist sentiment is most prevalent among the smallest of the surveyed companies and least so among the largest. So,

too — though the differences are not as wide—is advocacy of government subsidies, tax benefits, and loans.

	1984 Sales		
	Less than \$100 million	\$100 to \$999 million	\$1 billion or more
<i>Favor help for companies like theirs and/or others</i>			
Protection through tariff or quota measures	51%	44%	26%
Support through subsidies, loans, tax benefits	52	50	36

On the other hand, three-quarters of the largest firms indicate support for efforts to eliminate or reduce trade barriers through negotiations as compared with slightly over half of the smallest. Negotiations in pursuit of voluntary agreements are favored almost as often by firms that have themselves escaped competitive harm in recent years as by those that have not.

Protectionist measures—and steps to lower the value of the dollar—are far more likely to be favored by the harmed than the unharmed, however. Respondents who say their companies have been harmed considerably by foreign governments’ subsidization and export-promotion measures are six times as likely as those unaffected by them to favor higher tariffs or lower import quotas—71 percent as compared to 12 percent. Sixty-eight percent of those “harmed considerably” by imports from countries with lower labor, material or other costs favor higher tariff or import-quota barriers as against only six percent of those that are unaffected by such competition.

Arguing for Protection

A large majority of those advocating protectionist measures, subsidies, and the like, say they have come to this view reluctantly, usually arguing their case on the basis of equity or urgent national interests. Most appear to see protectionist moves as a temporary measure—a device that will give the United States leverage in seeking fair-trade agreements with other nations. “The era of managed trade has arrived and we do not believe in unilateral disarmament,” a steel executive says. Another, speaking for a metal fabricating firm observes: “We are increasingly more pessimistic about the prospects of free trade and bilateral trade-liberalization negotiations. It seems that foreign governments will respond only to genuine threats.” Some other comments:

A fabricated metal products company: “We have become increasingly aware in recent years of the growing unbalance of trade and its causes—namely, subsidies and other means of protectionism practiced in countries other than the United States. We are basically advocates of free trade and have strongly supported the Administration’s efforts to preserve it from protectionist elements. However, our current position is that immediate and decisive countervailing actions must be im-

plemented in the absence of open borders or truly reciprocal measures from our major trading partners, particularly Japan. Let's quit dancing around the basic question of reciprocity and use the leverage we enjoy as the world's largest and most attractive market before it is too late. We have talked long enough."

A primary metals manufacturer: "We want to see fair trade rules. But in the past five years it has become readily apparent that there is no 'fair' trade in the world in the face of: (1) foreign governments' subsidies to their industries; (2) overcapacity relative to basic needs, which requires subsidized foreign industries to export excess capacity to the United States; and (3) strong trade barriers to our exports of competitive products. The so-called free-trade concept under GATT exists only as a concept—the rest of the world espouses it, but practices strong controls of trade flows. The United States is naive in the trade area and must wake up before our industrial base is totally emaciated."

A musical instruments manufacturer: "It's a world market: all industries must be competitive on that basis. The U.S. policy of jawboning will not and has not worked, as seen in our trade relations with Japan. Strict trade parity on all products in all markets is the only language foreign exporters will understand. Until trade parity is a reality, strictly enforced—so that, if U.S. exports are restricted by any country, its imports into the United States will be restricted in a parallel way—no amount of U.S. government publicity or exhorting U.S. manufacturers to export will work."

A precision-tool and instrument manufacturer: "We want free and fair trade. 'Fair trade' means eliminating governmental actions that allow foreign companies to come into the United States and undercut prices. These actions—deliberately undervaluing the yen, for example—and various subsidies by foreign governments, are unfair. Protectionism does not mean protection against companies but against foreign governments' actions that make a mockery of free trade. There ain't no such thing today except on the part of the United States. The answer is to slap a 20-30 percent tariff on all imported goods until foreign governments rescind actions that unfairly favor their industries."

An oil, gas and mining company: "We have historically favored free trade—but on a level playing field. Our capacity to compete with foreign producers has been seriously and adversely affected by the strength of the U.S. dollar—a result of U.S. Government deficits, environmental regulations that have im-

posed substantial additional capital costs, subsidized loans to foreign producers, nationalization of foreign producers and their operation without regard to market forces, and excessively high labor costs (our fault). We have sought some relief through temporary quotas to permit us to improve our productivity and enhance our competitiveness."

A concrete products manufacturer: "We are not against imports that compete on a fair basis. We favor countervailing duties on imports that receive government subsidies from their home countries. We favor U.S. government intervention when a strong case is made that foreign imports are sold at 'dumping' prices."

Arguing for Free Trade

The 38 percent of respondents who oppose or do not favor either protectionist measures or subsidies for U.S. industry say they speak for the longer term interests of their companies, the nation, or the world economy. A paper products manufacturer states the extreme position: "We believe that no impairment of free trade can ever be justified. If other countries do wrong, it is in our self interest to turn the other cheek." Some other comments:

An oil company: "We have an aversion to subsidies, quotas and tariffs—all of which encourage economically inefficient activities. Thus, we support GATT and a vigorous prosecution of unfair trade practices when they occur."

A high-technology company: "We remain staunchly free trade, even though we acknowledge there are too many trade barriers and other considerations. Our business has benefited from a relatively open world trading system: We would profit from still freer trade, not closed markets."

A food company: "We oppose isolationism, nontariff barriers, dumping and all of the other major hinderances to free trade. We think the protectionist policies of the European Community and Japan are potentially disastrous, and hope the escalation does not result in a major trade war."

A machinery manufacturer: "We firmly believe that protectionism—by any government—is very harmful as it only invites retaliation and cuts the world market up in small pieces. A general elimination of trade barriers—in the United States and abroad—is the best cure for economic stagnation and for giving the best-managed company a chance to win the competitive battle."

V. Looking Ahead

Whether they favor more protection and government support for United States companies, oppose it, or have no definite opinion, most participants (71 percent) expect trade issues to become more important to their firms in the coming years than they are today.²

Some expect this as a concomitant of stepped-up investments and marketing efforts by their firms in foreign countries. As they "shift to overseas production to supply U.S. demand," or "look for increased international revenues to maintain sales and profit growth rates," or "expand international investments," firms expect their stake in trade-policy matters to rise correspondingly.

A second group sees no significant respite for their companies—or for the economy, or the country—from the factors that have been responsible for increased foreign competition, many expecting the damage to cumulate as time goes by. Some point to the fact that the United States market is attracting a mounting volume and variety of goods from firms in a growing number of countries. "The United States is the marketplace of the world," an electronics company executive says: "Every foreign country with manufacturing is trying to get a piece of the action by hook or crook."

Foreign governments often play a key role in this, participants note. A manufacturer of pumps says that Japan "has targeted the U.S. market and plans to buy its way into it" for national firms in that business. Similarly, an oil company executive anticipates that "Middle East expansion into the downstream petroleum business—that is, refining—will grow as a result of projects already under construction. The United States is the most likely target for their products." The difficulties mount, many respondents say, as foreign firms that have achieved a

"marketing presence" in the United States increase their productive capacities. "As foreign products gain acceptance, a snowball effect further erodes the hold of U.S. firms on their markets", a machinery manufacturer comments.

The competitive advantages enjoyed in recent years by the many overseas firms attracted to U.S. markets are expected to continue. "Foreign companies got their foot in the door because of the high dollar, and will move into the house as it remains high," one participant comments. Others make much the same point about the lower labor costs of less-developed countries and about foreign governments' aid to national firms.

United States' actions will probably worsen their companies' prospects in foreign markets, several comment. "We are a defense contractor," one says, reporting for an electronics firm, "and expect licensing of our products for export to be further restricted." Another in the same industry observes that "exporting electronics is becoming more difficult procedurally." Still another, a rubber-company executive, anticipates that the United States will make "additional concessions in GATT, including potential revocations of steel import quotas."

A quite different concern is voiced by executives still committed to free trade. Their fear is that rising pressures will make protectionism more difficult to "fend off"—and will draw their companies into a long-term struggle. A food company executive comments: "United States' protectionism could have a severely negative impact on our operations in the United States and worldwide."

About three participants in ten do not expect trade issues to become more important for their companies in the coming years. Most do not think they will become less important either—or represent firms that have escaped harm from foreign competitors. Five of the participants do expect trade issues to become less important for their companies in the years just ahead than they are now. In at least one case, this is because the company is withdrawing from foreign markets. In others, it reflects the belief that government help is not far off.

²The five-nation agreement of late-September, 1985, aimed at lowering the value of the dollar, and the recent commitments of the Administration to support U.S. business in other ways as well, occurred after most responses to this survey were prepared. But follow-up inquiries with 24 participants suggest that business views about the trade outlook have changed little, if at all, as a result.

**Research
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No. 188

The Conference Board**Labor Outlook 1986***by Audrey Freedman and others***Management Summary**

- Wages and compensation will increase modestly in 1986—just about keeping pace with inflation.
- Unemployment will remain at about the same level (7.1%) throughout 1986. New job creation will equal the normal growth of the labor force.
- The wave of corporate restructurings will continue. It is undermining the career security of executive, managerial, and salaried employees. Their confidence in corporate stability may be giving way to a more self-determined and self-reliant behavior. The organization man, the “company-minded man,” may not return.

HUMAN RESOURCES PROGRAM

THE CONFERENCE BOARD'S 1986 LABOR OUTLOOK PANEL

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The Conference Board
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The Conference Board's annual session on the labor outlook took place on November 7, 1985. Panel members discussed the current economic situation, compensation trends, human resource developments, labor relations, and political events. This process provided the predictions for 1986. The individual views quoted were submitted by the participants before the discussion.

*Mr. Bahr provided his views, but did not attend the meeting.

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LABOR OUTLOOK 1986

Crosscurrents and contradictions ran through the panel discussion of the 1986 outlook. On the level of the economy, there was general agreement that a serious recession is not going to take place next year. Yet the group was very much concerned about the uniquely unfavorable economic policy choices that are developing.

At the level of private firms, the restructuring "rampage" (as one panel member characterized it) was seen as making industry more efficient. Yet the resulting insecurity is changing "the implied continuity of corporate careers." Now young managers and older ones can assume nothing about the reliability of regular advancement. Traditional corporate cultures of security, especially for salaried workers, are shattered.

Finally, at the level of the individual, the panel sees more optimism, more risk-taking and self-determining behavior. Yet there is a concern that complete individualism may undermine a society that relies on family, community and employment to discipline individual self-determination.

The overall economy will remain stable throughout 1986, though the panel expects little growth. Two members anticipate a recession this year, but one thinks it will be short and mild. Nevertheless, "if we begin a recession, the classical solutions are not available." There are serious economic dislocations. We have been "getting by," but our institutions—especially the banking system—are fragile. A much greater degree of competition within the U.S. and worldwide also feeds this sense of riskiness. Corporate reorganizations and realignment of industry structure are attempts to become more effective at competing in the world market. With customary business optimism, the panel suggests that the "accident" that might cause a crash will not occur, and that the U.S. will get through an additional year of very slow growth. The charac-

teristics of this stable, even stagnant, economy are shown in Table 1.

Unemployment is not expected to rise. Since the labor force will grow by one to two million persons, a stable unemployment rate implies that there is at least this much job creation energy left in the current recovery. The 1985 picture, of just enough new jobs to absorb labor force growth, will continue.

Inflation is expected to remain relatively quiescent. The consumer price index measure has risen at a 3.2 percent annual rate in the first three quarters of 1985; the panel thinks we will experience slightly more price pressure next year. One reason may be the gradual decline of the dollar. Import prices rise correspondingly, and domestic producers can also raise their prices. Moreover, the pace at which the Federal Reserve has allowed the money supply to expand may begin to raise inflation levels.

Wage levels are also going to remain subdued. Average hourly earnings for non-supervisory and production workers (about 80 percent of the entire U.S. workforce) rose 3.2 percent in the year prior to October 1985. The panel projects a slight increase, to 3.6 percent during 1986. For union bargains,

Table 1: Forecasts for 1986 by The Conference Board's Labor Outlook Panel

	Median (Percent)	Range (Percentages)
Overall increase in average hourly earnings, January, 1986 through December, 1986	3.6	3.0 to 4.0
First-year wage and benefit increases in major union contracts	3.5	3.0 to 4.5
Increase in labor costs per unit of output in manufacturing	1.7	.5 to 2.8
Rate of inflation (average increase in Consumer Price Index)	4.0	2.9 to 4.7
Unemployment average during 1986		
First quarter	7.1	7.0 to 7.7
Second quarter	7.1	6.9 to 8.0
Third quarter	7.0	6.8 to 8.5
Fourth quarter	7.1	6.8 to 8.0

Measurement

Throughout the panel discussion there were questions about data quality. None questioned the integrity of government data; but everyone, at some point or another, raised issues about the meaningfulness of a data series. The industrial divisions for reporting are out-of-date, and the occupational taxonomy is built upon ideas of status rather than job responsibility and function. The wage data omit important new pay items like lump sum amounts. The productivity data are not congruent with these business executives' observations. The data on savings are not comprehensive.

While it is possible that this is a natural reaction to bits of unfavorable news—picking them apart because they suggest a flaw in the good feelings of the observer—the likely possibility is that the most measured economy in the world needs to update its categories and provide for new developments in its "old" measures.

next year will be somewhat higher than 1985. So far this year, fully a third of workers with new contracts got no wage increase in the first year (though most of these were scheduled to get some increase in the second or third year). The panel may expect these wage standstills to be less frequent in 1986. Asked to estimate the first-year wage and benefit increases in new 1986 contracts, the panel answered with a range from 3 to 4.5 percent. The entire compensation picture, suggested by these projections and those in the box on p.13, is that employment costs will rise between 3½ and 4 percent during 1986.

Unit labor costs in manufacturing are expected to increase 1.7 percent during 1986. With hourly wage costs rising, as the panel said, about 3½ percent, it is clear that the panel does not expect much productivity growth. (Unit labor costs are, roughly, hourly wage advances *less* increases in output produced per hour.) Its unit labor cost projection implies that productivity growth will be less than 2 percent in manufacturing. In 1985 so far, manufacturing productivity gains have exceeded this record—but only slightly.

The Labor Market

The overall labor market improvement that occurred in early years of this recovery is now reduced to a slow pace that will probably be maintained in 1986. Most of the panel members observed that job growth is not taking place in large companies, and that these may still be cutting their workforces in 1986. Joe Duncan noted that small businesses are the job creation engine of the present economy:

"I look for modest economic growth in 1986 and consequently a very small reduction in the overall unemployment rate. However, I would point out that the unemployment rate is probably not the best measure for evaluating the labor market. The employment/population ratio is a better indicator. Currently the ratio is nearly 60%, which is a significant improvement over the 57% of 1974, one decade ago (1975 was even lower).



JOSEPH W. DUNCAN
Corporate Economist and Chief
Statistician
The Dun and Bradstreet Corporation
New York, New York

"During the current economic expansion, a major source of employment gain has been in smaller businesses. Our estimates suggest that over 70% of the new jobs created during the expansion have been with enterprises whose total employment is less than 500 workers. Nearly 30% of the new jobs have been created in firms with fewer than 20 employees. Since these smaller firms are frequently in the service sector, and since they include a number of activities that require relatively low skills (restaurants, retail outlets, business services such as cleaning, repair, etc.), there is the prospect that employment gains can be maintained among persons of lower skill levels."

The Communications Workers is a service industry union, with a manufacturing component in electronic equipment. From a union viewpoint, the employment market looks particularly bleak. Morty Bahr:

"The unemployment picture for 1986 is gloomy. The present unemployment rate of over 7% is unacceptably high. A decade ago, we would have considered this rate of unemployment to be an indication that the economy was in a recession. Today, the Reagan administration congratulates itself when unemployment declines briefly to 7.0 percent in August 1985. The unemployment rate will probably return to its plateau of 7.3% to 7.5% during 1986, and may even increase to 8%.

"Despite the Reaganites' glowing optimism, millions of Americans are out of work, and underlying problems in the economy will cause this number to grow rather than shrink in 1986. America is losing its industrial base. Over 34 months of recovery, the manufacturing sector has regained only 53 percent of the 2.3 million jobs lost during the 1981-82 recession. Every job lost in manufacturing causes secondary job losses in the service sector. As a result, the number of long-term unemployed continues to grow. During the third quarter of 1985, the number of discouraged workers who have given up looking for work increased to about 1.2 million, or 90,000 more than in the second quarter. In addition, 8.3 million unemployed workers were actively looking for work in September 1985. Because of continuing cutbacks in unemployment benefits, the majority of unemployed Americans now receive no unemployment benefits. This

fact alone bodes ill for the national economy in 1986. The resulting lower demand for goods and services can be expected to dampen GNP and employment growth next year.

"Unemployment breeds continued unemployment. But other, more fundamental problems threaten the prospects for continued economic growth. The most important is the huge Federal deficit, created by Reagan's tax cuts and massive defense expenditures, which drives up interest rates and over-values the dollar. These factors, in turn, slow economic expansion and contribute to the flood of imports. An estimated three million Americans have lost their jobs because of import competition. Early 1985 marked a turning point in the world economy, as the United States shifted from being a net creditor to a net debtor nation for the first time since 1914. The U.S. is now dependent on the rest of the world for financial security. Given the tenuous situation of the heavily indebted developing countries and the continuing economic problems of the developed countries, there may be little financial security available from the rest of the world. All these factors point toward another recession within the next five years.

"The trend in telecommunications reflects the overall problems in the U.S. economy. Total employment in the industry declined by about 13% between 1982 and 1985: New technology makes it possible to meet growing demand with fewer workers. At the same time, AT&T's decision to move telephone manufacturing to Singapore and other low-wage countries causes more job losses.

"Unless there is a sudden change in national policy, several elements point to a serious recession in 1986 or 1987. Already-high unemployment will dampen demand, causing even higher unemployment. The Federal deficit will continue to grow, driving up interest rates and slowing the recovery of the auto and housing industries. The strong dollar will encourage more imports, causing more mass layoffs and plant closings. Finally, the debt crisis in the developing countries will stifle U.S. efforts to turn around the trade deficit. Their internal economic problems will keep them from providing the markets we need to revitalize American export industries."

In the discussion, one person mentioned that there is a dearth of young people at entry age. As a consequence, some industries that depended on such workers (like the fast food outlets) are searching for help. They may have to re-design the jobs, and their appeal, to acquire enough older workers.

Management efficiency drives are cutting out excess layers and staff in large companies. The group discussed trends toward decentralizing, and centralizing, and decided that both movements are occurring. Management of large firms is being decentralized to shift responsibility and risk. Spinoffs are a more complete form of the same move. At the same time, some staff work is being centralized to avoid duplication at

the business unit level. From a corporate viewpoint, such duplication is actually overstaffing.

While salaried employment is being cut back, firms are also hiring right now. Some new potential managers must be brought in, to prevent the reduced vitality that would otherwise occur. To outsiders, and especially to unions, it seems paradoxical that workforce reductions should be announced, with attendant "early retirement" policies, while the company is recruiting on campuses.

The Effects of Restructuring

In the labor market of large-scale private industry, corporate restructurings are having a heavy impact. Non-supervisory workers, nearly always affected by cyclical downturns, are also being touched by divestitures, acquisitions, and other redeployment of the corporation's resources. But now, salaried workers, managers, and executives are similarly at risk of being transferred, downgraded, retired, or simply let go. Mitchell Fromstein suggests that the new atmosphere is a response to increased competition:

"The relative comfort and complacency of corporate management in the 1970's was brutally buffeted by successive shock waves of the 1980 and 1982 recessions, the ravages of the strong U.S. dollar, the emergence of offshore low cost producers, selective deregulation and long-term build-up of an aging and overweight U.S. industrial machine.



MITCHELL S. FROMSTEIN
President & Chief Executive Officer
Manpower, Incorporated
Milwaukee, Wisconsin

"If economic prosperity continues even at a sluggish rate, the restructuring will likely continue at a brisk pace. If, on the other hand, we slip into a recession, the retrenching is likely to grind to a halt as merger and takeover activity fade and companies concentrate on the marketplace instead of their structures of ownership.

"The initial remedial focus was on technology, productivity and streamlined production facilities but it shifted, very quickly, to the more effective employment and deployment of a firm's workforce. It began at the lowest levels but, eventually, has crept up the organizational ladder where virtually everyone's productivity and

necessity has come under close scrutiny. The mergers, acquisitions, leveraged buyouts and divestitures, in my opinion, merely provide the opportunity to complete the process begun in the recessions of reducing the total human resources cost of an enterprise. The same human resources effects attributable to corporate ownership change are, in fact, showing up in large enterprises where no change in ownership has taken place or is contemplated.

"The objectives of this broad restructuring trend seem to be twofold: First is an effort to remain competitive in the face of new pressures and insure the survival of an enterprise; and, second, to restore or protect an acceptable level of profit return on invested funds or meet the interest costs on borrowed funds.

"Whether it is 'churning of ownership' or planned restructuring, however, this trend certainly does have profound human resources effects. The harshest impact from a human viewpoint is created by staff cuts and job losses at all levels. One must bear in mind that the complacency of the 1970's era created an over-population of employees in most sizable companies, particularly at the managerial level. Close examination of a corporation's structure usually uncovers a thick layer of expendable executive and managerial costs that add little to productivity and growth, but significantly affect profits and operating flexibility. The 'layer' includes duplicated functions, obsolete positions and inefficient operations. As these layers are trimmed or eliminated, a substantial number of support people as well as executives and managers are made redundant.

"While the people who are terminated in the restructuring process have a tendency to see the process as capricious, the rationale of management is the creation of a more viable, productive and lean organization based on economic necessity.

"The social discomfort involved in the restructuring process is quite another matter. Whenever large scale terminations take place, there is at least a temporary dislocation of jobs, income and personal life. Broad scale and precipitous terminations without notice or severance provisions can leave the workforce in dire circumstances, particularly in smaller communities where a limited market exists for replacement jobs. Because the large scale restructuring is taking place in a period of economic growth (rather than recession), the job-holders find replacement work more easily and quickly. The most difficult cases are people in advanced age brackets with skills and experience that have become obsolete in a changing technical environment. Some of these people are covered by early retirement plans or severance pay programs but many are not.

"Insecurity rising from the restructuring trend is difficult to measure but is certainly a prevailing social factor. Virtually everyone involved suffers some permanent loss of a sense of job security. One broad result is

substantial weakening of the ties between individual and corporation. This sense of 'community' which has long pervaded the American labor scene has disappeared at least for a decade while the scars of restructuring will be visible.

"In fact, however, the real security of those who remain will be substantially strengthened. The restructuring process, when complete, leaves a lean organization that is highly dependent upon a smaller group of essential people at all levels. This group of survivors will likely be protected, better compensated, covered by better benefits and, in every way, more secure than they were in the previous organization. Thus, while the perceptions of insecurity will prevail, the reality will be quite different in most instances.

"It is highly unlikely that a newly-restructured organization will quickly return to a policy of over-hiring to meet fluctuating workloads. While the society is left to deal with the problems of short-term dislocations, the emerging structures should be better-equipped to face future market conditions and cyclical swings.

"In short, I believe we are moving to a structure where cyclical layoffs and terminations will be much less frequent and the continuity of working life will be more dependable.

"Shifts in ownership and restructuring are resulting in changes (sometimes a complete reversal) in previous human resources policies. This is not only an expected result of the actions previously described but it is, in fact, sometimes the prime motivation for that action. Structural change, whatever the cause, opens the door for management to correct or modify those policies that have grown in a different environment. Thus, competitive wage levels, hiring practices, fringe benefit programs and traditional perks of every kind become a principal subject for re-examination. In the case of ownership change, the previous policies are simply abandoned without notice or explanation. In the case of planned restructuring, they are labeled 'take-backs' and are carefully removed or negotiated downward with an existing labor organization. The result is the same. Only the methods used are different.

"It is worthwhile, I believe, to note here that organized labor is responding in a very mature and responsible manner to this phenomenon—often more responsibly than the management who reverses the policies. In many cases, it was poor management policies that created the problems being solved by the 'take-backs' and, yet, union leadership frequently accepts the results in a very pragmatic way. (Perhaps the realities of the workplace are often better understood by the troops than by the generals who rely on theory and concept in planning strategies.)

Alan Ewalt said that, in the course of restructuring, his company had shifted its "values." Again, the pressure of new competition is the cause:

ALAN R. EWALT
Senior Vice President
National Medical Enterprises
Los Angeles, California



"Our own company's history of paternalistic human resource practices has been challenged by the dramatically changing competitive structure within the health care industry. These practices have been re-examined and reviewed with some significant cultural impact. When the values of loyalty, efficiency and productivity clashed, there was a healthy but necessary reordering. The implication is clear to our employees that there is a renewed and heightened emphasis on efficiency, not just effectiveness, and the shift in balance is having important ramifications at all levels as the organization streamlines.

"The 1986 environment is different from previous environments. Because 'churning' is happening in a number of industries—communications, banking, transportation, health care—it is viewed as non-company specific and is a sign of the economic times in 1985. If nothing else, this environmental issue makes the implementation of corporate restructuring perhaps slightly more palatable to our employees than if we were the only company realigning itself. The human resources consequences are more significant today as dissimilar cultures come together in a merger: benefit plans are incongruent, incentive plans must emphasize new kinds of outcomes; companies that are downsizing may be reversing policies or terminating good performers because of a change in the market emphasis.

"Incidentally, I have seen a substantial increase in the number of professional outplacement organizations that are either newly formed or are expanding their activities to help employers cope with restructuring, particularly focusing on supporting longer-term employees."

Ben Dial linked the effects of restructuring to technological change and progress in the economy. Then he added that a high level of job loss "shock" might bring some public policy reactions.

"The growth in domestic, information-age employment opportunities has not yet offset the irretrievable loss of production jobs. If U.S. production increases, it will be in highly automated plants using technology such as robotics to undercut foreign labor costs. This scenario offers poor re-employment prospects for American unskilled and semi-skilled workers.

"Advances in computerized data processing capabilities, including major strides in artificial intelligence and user-friendly information access, will apply additional downward pressure on traditional middle management, staff and clerical support jobs.

"The proportion of total operating costs attributable to employee-related expense grows as the workforce's orientation shifts from production/industrial to information services. Traditionally, line-production environments could expect approximately 60% of total operating costs to go toward wages, salaries and other employee expense; staff environments could expect closer to 80-85%. The information-age workplace emulates the traditional line environment, particularly in cost allocation.



BENTON W. DIAL
Executive Vice President-Human
Resources
Pacific Telesis Group
San Francisco, California

"It follows that, for firms cutting costs to improve competitive posture, the human resource becomes a primary target.

"Although it is unlikely that many companies will guarantee employment in a free enterprise system, it would be disadvantageous for U.S. firms to act callously toward employees. Such an attitude would exacerbate the morale and productivity problems already attributed to job insecurity. If U.S. businesses will not protect the American worker from unemployment, then eventually the U.S. Government will be much more apt to legislate protection. An example of such legislation already pending is H.R. 1616, which would require employers to give a 90-day advance notice of any plant shutdown involving fifty or more employees. Another bill, recently introduced, would lower pension fund vesting requirements for a deferred vested pension while simultaneously enabling employees to take their accrued pension benefits with them, without loss or penalty, when they leave one employer to join another."

Use of Contingent Employees

"The trend toward hiring contingent employees is the most significant change in labor markets occurring today"—Joe Duncan. Pete Pestillo explained why:

- "Organizations need to respond rapidly and agilely



PETER J. PESTILLO
Vice President-Employee Relations
Ford Motor Company
Dearborn, Michigan

to changing customer demands. Markets are increasingly specialized/customized.

- "Significant overhead and labor cost savings can be realized, and today's and tomorrow's competitive pressures provide the compelling need to hold down costs, especially in labor-intensive industries.
- "Temporary employees provide employers greater flexibility in dealing with workload peaks and valleys, whether they be daily, weekly, seasonal, or to meet the needs of a specific project.
- "The traditional need for temporary employees to cover vacations and absences remains, but with the rapid introduction of new technology in the office and on the factory floor, temporary replacements are needed with increasing frequency to cover training and retraining of regular employees.
- "'Outsourcing' of data processing, and information services, is available from specialized service-delivery firms and organizations.
- "The segment of the work force which voluntarily seeks temporary or part-time employment is increasing, i.e., homemakers and retirees who want to supplement income."

Duncan added that company incentives to use contingent workers, beside flexibility, are:

1. Ability to add workers with specific skills without the attendant costs of training or retraining.
2. Lower fringe benefits in the longer term, especially pension and health care costs.
3. Demonstration to current labor force within the firm that job security is not guaranteed, and consequently that efficiency and productivity are critical for continued employment of the individual worker."

Bill McCann described a variety of arrangements: permanent part-time, single-company temporary arrangements, employment within a contract leasing company or temporary help service, and free-lance or self-employed consultant. He then described some arrangements that are specific to the trucking industry:

"In our city pickup and delivery operations, frequently the need occurs for the transportation services provided

by small local cartage operations at certain times of the week when our business is the heaviest. These 'cartage' companies employ their own people and provide a more timely and efficient service in periods of fluctuating business.

"Another example involves shippers who employ leasing companies to perform their entire transportation service on a contract basis, either instead of or in addition to their own transportation fleet.

"A third example involves the use of 'casual' employees in our dock operations as needed to replace absentee regular employees or as supplements to the existing operation as a result of a temporary increase in work flow.



WILLIAM F. McCANN
Vice President-Labor Relations
Consolidated Freightways Corporation
Menlo Park, California

In recognition of the need to continue this type of operation and in light of the competitive developments since deregulation, the Teamsters agreed in contract negotiations this year to allow employers to use casual employees at a wage approximately 20% below the full contract rate, in exchange for assurances that companies would add regular, full-time employees under an agreed-to formula.

"In over-the-road operations many companies are utilizing independent contractors or owner operators who are employees of fleet owners to move inter-city freight, again providing the flexibility to smooth out cyclical or seasonal surges."

Alan Ewalt described contingent employment arrangements that are particular to the health care industry:

"Our industry has always been strongly oriented toward the use of part-time and contingent employees. We refer to contingent employees as 'on-call.' Such an alignment is essential to adapt the staffing levels to meet required patient care at variable patient census levels. This practice is less dramatic in non-acute care sectors of our company where there is a steadier demand, but there is still an emphasis on the use of part-time and on-call employees. Our hospitals also maintain an in-house registry of nursing and medical talent which is used to meet 'flex' staffing needs.

"In the administrative area we increasingly use temporary help to meet periodic demands of extra workload, vacation, etc. Our corporate response has been to

develop a pool of talent as corporate floaters that is available for use in various departments, but not permanently assigned to any one.

"Employee leasing is an option that appears to be popular for physicians' offices, but has not caught on in the rest of the industry. We experimented with employee leasing, but were not enthusiastic about results and eventually sold the subsidiary."

In banking, Irving Margol sees a growing part-time workforce, enabling the system to staff for peak operations only when needed. The output-per-hour of part-timers, then, is maximum:

"My organization has used hundreds of temporary employees for years. This type of individual is hired as our own employee, but is hired knowing there is no promise of job security since the position is temporary. This type of employee continues to be very valuable during peak hours in banking offices and certain production areas such as proof operations. They have also been an excellent source for staffing regular positions as they occur. The use of the temporary employee has minimized the need for downsizing regular staff during slow periods.

IRVING MARGOL
Executive Vice President
Security Pacific National Bank
Los Angeles, California



"We have also used temporary agency personnel on a more limited basis. I do not see a trend toward an increase in the use of temporary agency personnel or leasing in the financial industry. However, we do see a trend toward the use of more regular part-time employees."

Mitchell Fromstein pointed out that one part of contingent employment, those working for a temporary help service firm, has grown about as fast as employment generally—not faster. At present, the temporary help service industry has about 600,000 people at work in any one week. Temporary work rises and falls with the business cycle, too. However:

"The general use of contingent workers of all types has increased and the trend has created large numbers of jobs for contract workers, self-employed individuals, part-timers, etc. These positions, however, do remain precarious from a job security viewpoint. The temporary help service industry is able to reassign workers who are no longer needed on a specific assignment or project,

thus lightening the impact of workforce shrinkage on that group of contingent workers. In addition, the larger temporary help firms provide their workers with at least a safety-net group of benefits (health insurance, vacation, holiday pay) to replace the absence of benefits among contingent workers.

"Employee leasing is a totally different phenomenon which involves the transfer of permanent employees to the payroll of an outside firm. It is usually motivated by a desire to unshoulder pension responsibility, collective bargaining problems and other employee relations issues. It is found most frequently in small firms that want to avoid the obligations, cost and involvement of these programs. In my opinion, it does not belong, logically, among the flexibility options as it is not flexible. Further, I believe it is a fad with limited application which will ultimately disappear or be legislatively removed from the business scene."

The use of contingent employees as a "buffer," to protect the employment security of regular employees, has been noted by many analysts. Where a company is trying to stabilize employment for part of its workforce, it will be under pressure to designate an area of insecurity at the margin. This area will be occupied as needed by one or another kind of contingent workforce. Ben Dial spotted this kind of arrangement in the Saturn contract:

"Contingent employees are used as a buffer to protect regular employees from cyclical increases and decreases in demand. Many of the firms that use temporaries do not have union-represented employees. However, the Saturn agreement between the UAW and General Motors suggests that organized labor may not necessarily oppose using this method of securing employment, as long as the mass of employees is protected. The Saturn contract calls for protected members and less protected associate members."

Peter Pestillo, speaking from an auto industry vantage, has some negative undertones in his assessment:

"For those who have to accept temporary or part-time work as a compromise, i.e., involuntary part-time, this condition becomes a personal hardship. For many, they 'hang in,' hoping that an opportunity for regular full-time employment will occur. There is no question that this phenomenon can create personnel problems, and over time, the lack of attachment leads to a lack of identification, loyalty, and interest in helping the organization achieve its goals. Worse, a feeling of exploitation could develop where the individual perceives that his or her temporary status is becoming permanent—without benefits.

"While unions may not like the trend (whether the temporary, part-time or contingent employees are organized or not), the employer community will not be inclined to risk loss of flexibility or their company's survival by abandoning such options. As unions press

for greater job security for their present members in pursuit of 'life-time employment,' the pressure for employers to designate a significant portion of future hires as temporary employees has the potential for providing greater stability to regular full-time employees.

"Compromises are emerging from collective bargaining, some of which could be characterized as 'pilots' or 'experiments.' A clear picture has not emerged, and various forms of this issue will continue to be on the table well into the future."

Morty Bahr is totally opposed to the use of contingent workforces:

"There are many pressures for the increased use of 'contingent,' or temporary employees. Some companies which are widely viewed as models of excellent employee relations, such as IBM, use temporary employees as 'buffers,' adding them during busy times and laying them off during recessions. Although this benefits the 'permanent' employees and allows a policy of lifetime job security, it does so at the expense of another group of workers, the temporaries. For this reason CWA has always opposed and still opposes the use of temporary employees, contractors, and part-timers.

"Although uncertainty in the economy, the high costs of full-time employees with benefits, and the high unemployment rate all encourage the increased use of 'contingent' employees, this trend is unlikely to continue. The most important reason is that it hurts workers. Temporaries have no job security, often lack fringe benefits, and may be required to work either more or less hours than they would like. They may be paid on a piece-work basis for work such as word processing, which causes tremendous stress along with the anxiety of not knowing whether they will be employed tomorrow. While a few energetic younger workers may enjoy the independence and temporarily high earnings they can achieve by working quickly for long hours, over the longer term they are unlikely to accept such situations. The first time a single mother working as a temporary secretary without health benefits falls ill, she may get by on savings or on free service by community hospitals. But she will see to it that this does not happen a second time by finding a more secure job.

"The reason that the use of temporary employees is unlikely to increase is that it hurts the companies as well as the workers. Firms that are unwilling to commit to their workers by hiring them as full-time employees cannot expect any commitment from the employees.

"Companies that rely on temporaries or contractors hope to reduce the costs of training and other investments in employees. But failing to invest in their most important asset—their human resources—may turn out to be a costly mistake in the long term. Retraining current employees is often less expensive than hiring contractors who don't know the company's rules, procedures and overall culture. One telephone company has decided

to retrain its own cable splicers in fiber optic cable splicing, rather than hiring a contractor as it had planned to do. Company and union agreed that it was most cost-effective to retrain current employees who knew the terminology, health and safety practices, and driving skills required by the company.

"The final reason that the use of 'contingent' employees will not increase is that unions will not allow it to increase. CWA recently went on strike against a Bell Operating Company that hired contractors to install switching equipment. The strike was settled when the company agreed to use its own employees—our members—to do the work. Our position is that all use of contractors and temporaries must stop, and we are prepared to take any action necessary to stop it."

In the discussion, contingent employment was regarded as another form of "two-tiered" arrangement (somewhat like union bargains that allow lowered wages for any new employees hired after the contract is negotiated). When the group agreed that many employees want and seek this kind of work, one member observed that employers often think people "really prefer" the only choice available to them. In this case, less employment regularity may be the only option open in today's labor market.

Employment-at-Will

In some jurisdictions there is a growing weight of legal opinion that limits the employer's power to discharge without cause. Dan Mitchell gave this as a reason for hiring contingent workers:

"The legal system—especially here in California—has been moving in the direction of adding to the employer's obligation to employees. Wrongful discharge suits have become big business in California. Some employer groups have actually promoted a bill in the legislature to provide for arbitration of discharges with limited remedies. They would like to get control of what is viewed as a runaway situation. Use of temporaries tends to remove the legal obligation. Courts would be unlikely to view an employer as having heavy obligations to someone who has an explicit, short-term agreement. (Employee leasing and hiring workers as self-employed contractors falls into this category.)

"I suspect that in a few years, California will have some state legislation in this area. South Carolina has a mechanism whereby a state body may intervene on behalf of a discharged employee. Cooperation with the program is entirely voluntary on the part of the employer. I have heard mixed reports of the effectiveness of this approach. But one can imagine other states going the voluntary route as a compromise, on the argument that we should see what can be accomplished voluntarily before setting up a mandatory system.

"One issue to consider is the remedy in discharge cases. Under the traditional arbitration system in the union sec-

DANIEL J.B. MITCHELL
Director, Institute of Industrial
Relations
University of California
Los Angeles, California



tor the remedy for improper discharge is reinstatement with back pay. My understanding of the European approach is that monetary damages are more likely to be the remedy. Indeed, there have been a number of cases involving high level executives where it must be assumed that the remedy being sought is money, not reinstatement. More attention should be given to the money damages option. (Maybe even arbitrators under union-management contracts ought to be considering it.)"

Panel members agreed with this. One observed that when an employee is placed back on a job by an arbitrator, "he never works again."

David Lewin pointed out that this is one of at least three employee relations subjects where state, rather than Federal,

DAVID LEWIN
Professor of Business
Columbia University
New York, New York



regulation seems to be developing. He suggested that some human resources law will thus become "Balkanized":

"One of the difficulties faced by employers with respect to the unjust discharge phenomenon is that in the absence of a Federal statute governing decisions in this area, each state in effect makes its own policy, typically through the common law. Therefore, a firm operating in several U.S. states must monitor legislative and judicial developments in those states in order to know how to respond to claims of unjust discharge. This is comparable to employer monitoring of comparable worth and plant closing developments at the state government level—two other areas of human resource management that are not regulated at the Federal level."

The group discussed what the legal or legislative outcome would be, but did not agree. Some felt that the court system would develop the law. One said, with resignation, "large multistate employers need consistency, so we will probably go for Federal regulation, accepting whatever penalty comes with the need for nationwide consistency." Most of the panel felt that there is a potential for enhanced labor market regulation in the current multiplicity of state "initiatives," but not in the near term. Mitchell Fromstein concluded:

"The ultimate result will most likely be a legislated termination process, particularly for non-executive employee levels."

Morty Bahr agrees:

"The growing success of unjust dismissal suits gives greater protection to the large segment of the American work force which is not yet unionized. Employers may find themselves faced with new organizations such as worker associations formed with the help of unions. CWA is prepared to tap the discontent reflected in the growing number of unfair dismissal suits through any and all means. We will represent workers as members, associate members or through other forms of organization, depending on their needs and desires. More and more companies are realizing that although they can avoid unions they cannot ignore the basic employee rights that unions provide without reprisal.

"Despite their best efforts, employers will find their actions restricted by state and Federal laws. As this awareness grows, employers may slow their sophisticated and often illegal tactics to stop union organizing. Given the choice between dealing with a complex web of laws and rulings and dealing with a union, employers may decide that unions are not so bad after all."

The threat of lawsuits is also changing personnel practices, as Ben Dial reports:

"The increased likelihood of litigation and the potential for large damage awards have forced employers to scrutinize decisions to dismiss or demote employees. Because many of the decisions expanding employees' rights are premised in part on 'implied contractual terms emanating from corporate practices and procedures,' employers have been reviewing all forms of communication and modifying any statement which might imply unintended rights or obligations. Some employers have modified employment applications and other appropriate documents to disclaim contractual intent and to affirm the company's right to dismiss an employee with or without cause. There is also an increase in the use of formal employment contracts at both upper and lower levels of management.

"More employers are developing outplacement procedures to head off potential litigation. These procedures may include job counseling and monetary payments. The use of internal review procedures allowing employees to challenge adverse decisions is also on the rise."

Irving Margol gave some examples from his bank:

"In order to avoid legal problems, Security Pacific has rewritten and updated all policy manuals which may suggest indefinite job security. One example is the following section which was recently added to the Personnel Manual and the 1985 Bank Policy Book: 'Nothing in this handbook or in any other communication, either written or oral, by any representative of the bank, made at the time of hire or during the course of employment, shall create or is intended in any way to create a contract of employment expressed or implied.'

"If, for any reason, an employee is discharged, it must be approved by an employment officer, and all relevant bank policies are strictly enforced.

"In those discharge cases of a more controversial nature, a long-standing employee may be given full salary for a pre-determined period of time, even though he or she is no longer reporting to work. Voluntary terminations handled in this manner are believed to save the bank money in the long run as they may avoid future monetary loss in court battles."

During the discussion of unjust discharge suits and countermeasures, one panel member observed dryly: "Human resource management flourishes as a career when there is an external pressure."

Wage Trends

"In spite of union concessions and the breakdown of pattern bargaining, union settlements still drive expectations." Two panel members agreed with this statement—then one quickly pointed out how much dispersion has developed among those settlements. All agreed that "one big number does not jump out anymore." Also, a much lower rate of inflation removes the other "big number."

Two bargains that will probably become dispersed to "many" appear on the calendar in Table 2: steel and communications. In steel, multi-company coordination has fractured and each company will negotiate by itself, tailoring the bargain to its individual needs if possible. The domestic industry's market is shrinking, as is its workforce.

In communications, bargaining will also be dispersed, because the Bell System was broken up by court order. Ben Dial observed:

"1986 will be a pivotal year for bargaining in the telecommunications industry. In no other industry have there been so many dramatic changes in the structures of its major players since 1983 contract talks. Both unions and management will be looking at 1986 as a course-setting opportunity.

"Competition and resulting public policy, of course, are the major forces driving such changes. They were beginning to occur long before the AT&T breakup. There had arisen an increasing number of telephone facility and equipment providers; Western Electric's monopoly

was gone long before divestiture. There were aggressive alternate providers of long distance services as long as ten years ago.

"In this new environment, competition will drive human resources practices and wage policies to be more aligned with local conditions. Wages will have to become more market-driven than before, balancing cost considerations with the need to attract and retain competent workers who have the technical skills sought by local newcomers to the industry.

"Another important consequence of this new competitive environment is a shift in what is expected of employees. If we are to be successful, a work culture must be encouraged that rewards customer-focused behavior, prudent risk-taking, continuing skill/educational development, and self-management. There is a movement toward a leaner, flatter organizational structure, and away from one that is governed by written practices and rules.

"The regional holding companies face another challenge. Most of the newcomers to the telecommunications industry have employees who are not currently represented by unions. AT&T will probably be faced with the same situation. This could give some companies a labor cost disadvantage, unless there is willingness between union and management to work together toward enhanced competitiveness. This has already started to occur at Pacific Bell. CWA leadership and senior management recently developed an employment security agreement that empowers local 'Common Interest Forums,' consisting of union local presidents and regional senior management, to make decisions on local conditions enhancing employee security and resolving related labor problems.

"A totally new group of bargainiers will be seated in 1986, representing eight increasingly different companies. The post-divestiture environment will probably find the regional holding companies all concerned about labor costs in their respective areas. However, as each begins to pursue these goals, diversity will begin to arise in most human resources practices. Local economic conditions, the state of the competition, the personalities of the bargainiers at the 1986 tables, and the evolving cultures of the companies will all contribute."

Morty Bahr observed: "AT&T was broken up. CWA was not." He will try to prevent differentiation from occurring:

"In 1974, CWA at last achieved a long-sought goal: a nationally bargained contract with AT&T. Because of divestiture, the last such contract was negotiated in the Summer of 1983. As we look ahead to 1986, one of our principal goals is to approximate national bargaining as closely as possible. We would prefer to negotiate as few contracts as possible and are now holding discussions with the companies about the possibility of having regional contracts. So far, BellSouth and Nynex have

A Survey of Surveys: Salary Plans

	<u>Level of Employee</u>	<u>1985</u>	<u>1986 Planned</u>
		<u>Salary Increase</u>	<u>Salary Increase</u>
American Compensation Association	Executive	6.7%	6.5%
	Exempt Salaried	6.4	6.2
	Nonexempt Salaried	6.2	6.1
The Conference Board	Exempt Salaried	6.0	6.0
Executive Compensation Service, Inc. A Subsidiary of The Wyatt Company	Executive	6.0	6.0
	Exempt Salaried	6.0	6.0
	Nonexempt Salaried	6.0	6.0
A. S. Hansen	Executive	6.3	6.3
	Exempt Salaried	6.2	6.1
	Nonexempt Salaried	6.0	6.0
Hewitt Associates	Executive	6.3	6.1
	Exempt Salaried	6.0	5.9
	Nonexempt Salaried	5.7	5.7
Sibson & Company	Executive	6.8	6.3
	Exempt Salaried	6.4	6.1
	Nonexempt Salaried	6.3	6.2

For the third consecutive year, planned salary increases are generally slightly lower than the average increase in the prior year. * However, the continuation of the present low rate of inflation would mean a real earnings gain for employees. (The Conference Board model of the U.S. economy projects the Consumer Price Index to rise 3.4% this year and 3.5% in 1986.) The modest salary increases planned for 1986 seem to indicate continued determination on the part of employers to control their compensation costs.

Charles Peck
Senior Research Associate
The Conference Board

* The actual change in pay over the previous year's ending payroll is usually about two percent less than the anticipated average increase.

agreed to regional bargaining, and our discussions with Bell Atlantic are promising.

"Perhaps the most drastic change in human resource policy which occurred as a result of the restructuring of AT&T was a shift in the attitude of the company toward the union. CWA and AT&T had grown and prospered together for 30 years, but following divestiture, several of the new Regional Holding Companies took a strong anti-union stance. Most of the RHCs have set up non-union subsidiaries and are vigorously opposing attempts to transfer to the subsidiaries by CWA to organize these workers. Organized workers who wish to transfer to the subsidiaries are required to quit their jobs in the organized, regulated side of the business before being hired by the new company. Many of the RHCs are also fighting CWA over the structure of 1986 contract negotiations. They want the union to negotiate separately with each of the local telephone subsidiaries, while we would

prefer to bargain with the central decision-making organization.

"Bargaining with AT&T should look very much the way it did in the past, except that the size of the work force has dropped from approximately 500,000 to 200,000. Bargaining will be on a national basis, and, despite the recent layoffs, relations with the company are good.

"The picture at the Bell Operating Companies is quite different. They are much more profitable than AT&T, and we expect a fair share of the profits. Our first goal will be to achieve regional bargaining. If the regional companies refuse to bargain on this basis, we will select one company as the pattern-setter and insist that all others accept the same settlement before the 'pattern' contract is signed. For example, there will be no settlement within the Ameritech region until we have a settlement in all five operating companies.

"Another important goal in our bargaining with the Bell Companies is improved transfer rights within the regional companies. The regional companies are hiring new employees off the street for their unregulated subsidiaries while laying off CWA members from the regulated Bell Operating Companies. They refuse to transfer our laid-off members because they would automatically carry contract protections with them under the divestiture consent decree."

Steel bargaining may result in a number of "early" settlements, perhaps even before the Steelworkers negotiate with the can (February) and aluminum (May) industries. Bill McCann wrote:

"If no additional protectionist legislation involving the steel industry is adopted by the time bargaining commences, the pressure will be on the management and the USW to develop constructive solutions for survival. Under these circumstances, I would expect individual bargaining by those steel companies designed to differentiate their contracts by product and/or location. The union may attempt to maintain some type of pattern conformity between companies where there are similar circumstances, but will be more cognizant of the need for differentiation.

"The end result will depend on the members' perception of their employer's financial and competitive condition, and their willingness to make the necessary wage

and work rule adjustments to ensure their continued employment and job security. This perception may vary widely among companies, and among different plant locations. It certainly places the responsibility for effective communications squarely on management's shoulders."

Union contracts may not provide that "one big number" that affects wage expectations throughout the economy, Dan Mitchell noted, but they have an impact on national averages. This is because union hourly wages, on average, are higher. Generally, the union weight in the average hourly earnings data is about one third. He went on:

"When you look down the list of upcoming contracts for 1986 you find some in lumber and paper, steel and cans, machinery, telephones, longshore (East Coast ILA), some retail foodstores and construction. Lumber and paper and steel and cans have been concession centers—as has machinery. Foreign trade problems will act as a drag on wage settlements in these industries in 1986. It would take a massive dollar devaluation to turn that situation around.

"The telephone industry contracts will be the first after the AT&T split-up. The CWA will have enough problems trying to coordinate the various settlements. Moreover, while the core of the local operating companies is still a regulated monopoly, there is a lot of nibbling on the margin and nonunion competition. Thus, the at-

Table 2: Selected Major Contract Expirations by Industry, 1986

<i>Month of Contract Expiration</i>	<i>Industry</i>	<i>Company</i>	<i>Union</i>
January	Oil	Major companies	Oil, Chemical and Atomic Workers
	Tobacco	Philip Morris, Inc.	Bakery, Confectionery and Tobacco Workers
	Food	Hawaii Sugar Cos.	Longshoremen
February	Retail Trade-Food Stores	Food Employers Council of No. California Food Employers Labor Rels. Council (Santa Clara)	United Food and Commercial Workers
	Fabricated Metals	Continental Can, American Can, National Can	Steelworkers
March	Communications	General Telephone Co. of Calif.	Communications Workers
	Health Services	Greater NY Health Care Facilities Association	Service Employees
	Glass	Owens-Illinois Anchor Hocking Brockway	Glass, Pottery, Plastics, & Allied Workers
April	Construction	Local multiemployer contracts expire throughout April-June	Construction craft unions
May	Lumber and wood products	Western States Wood Prods. Employers Assn.	Woodworkers
	Primary metals	Aluminum Co. of America Reynolds Metals	Aluminum, Brick and Glass Workers; Steelworkers

Table 2: Selected Major Contract Expirations by Industry, 1986 (continued)

June	Machinery	Caterpillar Tractor Co. Deere & Co.	Auto Workers
	Electrical, gas, and sanitary services	Consolidated Edison	Utility Workers
	Health Services	League of Voluntary Hosps. & Homes of NY & Other	Retail, Wholesale and Dept. Store Union
	Shipbuilding	Pacific Coast Shipbuilders	Metal Trades Council
July	Primary Metals	Wheeling-Pittsburgh Steel	Steelworkers
	Transportation Equipment	Pacific Coast Shipbuilders Assoc.	Various
	Machinery	Rouge Steel Co. Briggs & Stratton Corp.	Auto Workers Allied Industrial Workers
August	Primary Metals	Armco Inc. Jones & Laughlin Steel Corp. Republic Steel Corp. Bethlehem Steel Co. U.S. Steel Corp. National Steel Corp. Inland Steel Co.	Steelworkers
	Machinery	Timken Co.	Steelworkers
	Electrical machinery, equip. and supplies	Western Electric	Electrical Workers (IBEW), and Communications Workers
	Communications	AT&T, Long Lines Operating cos. including: Bell South Chesapeake & Potomac Michigan Bell Northwestern Bell Ohio Bell, etc. New England Telephone and Telegraph Co. Bell Telephone Co. of Pa. Plant Department NJ Bell Telephone Illinois Bell Telephone	Communications Workers Electrical Workers (IBEW)
	Retail trade	Waldbaum, Bohack, Daitch, others	Retail, Wholesale & Dept. Store
	Hotels	Casino Hotels of Atlantic City	Hotel Employees
	Shipping	Atlantic & Gulf Coast Shipping Assns.	Longshoremen
October	Transportation equipment	Boeing Co. Lockheed Aircraft Corp. McDonnell-Douglas Corp.	Machinists and various independent engineering unions
	Transportation	Greyhound Lines	Amalgamated Transit Union
	Air transportation	United Airlines-Ground Serv.	Machinists
	Retail trade	Jewel Food Stores	Food & Commercial Workers
December	Building Services	N.Y. Realty Advisory Board	Service Employees
	Transportation equipment	Dana Corp.	Auto Workers

Source: U.S. Bureau of Labor Statistics; Bureau of National Affairs.

mosphere does not seem right for a large wage settlement. Retail food and construction are two sectors that have had many concession deals, even though foreign trade and deregulation are not relevant. They seem to be working off past union/nonunion wage differentials. Unionization has fallen in construction. It's hard to get comparable data for supermarkets, but there seems to be nonunion competition coming into retail foodstores (or lower-wage union competition). There has been much two-tiering in retail food. If the UFCW wants to get rid of it, it will be hard pressed to obtain large general wage adjustments. And if it doesn't get rid of it, growing proportions of workers in the lower tier will tend to lower the average wage anyway.

"Longshoring is always volatile. But there are reports of nonunion and lower-wage union ports in the south which will put a damper on settlements in other ports.

"All in all in the union sector, it is hard to see sources of general wage pressure. Even if the wage freezes and cuts become less common (there has been some downward trend in these), there will not be any 'wage push' here.

"We now come to the nonunion sector. Nonunion wages have been outpacing union wages recently, a reversal of the pattern in the 1970s. Given the downward shift in the union wage norm which has occurred this pattern could well continue. But what is there that would suggest a significant acceleration in nonunion wages, which have traditionally been more market sensitive than union? The rate of price inflation is not likely to change much. Nor is the unemployment rate.

"One possibility that has been suggested for wage pressure is an alleged shortage of young, entry-level workers for demographic reasons. Indeed, the number of full-time workers in the 16-24 year age range fell slightly from 1984-II to 1985-II, according to the Current Population Survey. But that same survey reveals that 'usual' weekly wages for these younger workers rose more slowly than for older workers during that period. These data are very imperfect, since changes in 'usual' weekly hours may affect the results. But the point is that no signs of a youth labor shortage leap out from the available numbers.

"In summary, if you start with the question 'Why should the rate of wage increase be much different in 1986 from what it was in 1985?'—the answer is 'no reason.' "

The use of once-a-year "lump sum" payments, in lieu of wage increases, is spreading rapidly. The panel thinks that the practice will continue to grow, even though unions prefer wage

rate hikes. (Lump sums do not establish a new and higher wage level, from which the next increase is bargained. Moreover, they need not raise the cost of wage-related benefits such as time off. Finally, they present a noticeable amount in a check to the worker.) Dan Mitchell suggested that if a few lump sums were made contingent, flexing in amount with some company performance measure, they would become the union version of true pay-for-performance. If this happened, a union pay package or formula might be more linked to company performance than its salaried workers' compensation.

Tax Changes

There will be no taxation of health benefit premiums paid by the employer, the panel agreed. It was also in general agreement that 401-K plan contributions will retain their tax deferral. However, lower caps on the amount of salary that can be deferred may emerge, and much tighter restrictions and penalties for withdrawal prior to retirement. This move will force a new executive compensation policy for top-paid ranks—probably non-qualified, non-ERISA protected plans.

As Bill McCann observed:

"One out of four workers is presently covered by a 401-K plan, and their growth has been spectacular in the last year or two, with average participants saving about 5% of their salaries. Barring changes in the tax law allowing interest income to be tax exempt, development and expansion of 401-K plans is a step in the right direction to encourage increased personal savings and development of capital. However, it is more probable that contribution limits will be restricted, especially for higher salaried employees, and more strict withdrawal penalties imposed.

"In light of the more controversial provisions of the various tax bills, it seems probable that these areas would become subject to compromise as part of a bigger negotiated package. The potential buildup of tax-free money involved in a 401-K plan is too much to go unnoticed by legislators looking to 'enhance revenues' as a major solution to the budget deficit problem."

In Summary...

The most important fact about this outlook for 1986 is that it does not envisage a turning point in the economy. The sense of slow growth—even stagnation—is there. The sense that the U.S. economy is in a risky position is there. But The Conference Board's 1986 Labor Outlook does not expect a recession. Therefore, its projections for unemployment are flat at current levels. In fact, the entire picture is steady, with slow growth of productivity continuing.



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**Research
Bulletin**

No. 189

The Conference Board**The 1986
U.S. Economic Outlook:
Comfortable but Frail**

Summary of a meeting of
The Conference Board Economic Forum

Management Summary

- The Forum consensus paints the 1986 outlook in pastel hues: comfortable and subdued. From now to late next year, economic activity is expected to climb 3 percent and the general price level 4 percent, while interest rates hold at or near present levels.
- Until the dollar falls a lot farther, the two-track pattern of the 1985 economy—with manufacturing, mining and agriculture under heavy pressure from foreign competition, while construction and services do quite nicely—is likely to continue.
- Gramm-Rudman-Hollings has sharp teeth that, whenever the time comes, are going to bite painfully into Federal spending. Whatever comes out of this attempt to curb the deficit seems sure to include plenty of economic and financial turbulence.
- Any damage that these and other uncertainties might create does not appear to be imminent. Prospects for 1986 do, therefore, look favorable. Yet, there are many frailties in the economy that could seriously undermine the comfort people now feel about the outlook.

Economic and Policy Analysis Program

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A Goldilocks Economy

Edgar R. Fiedler

The November meeting of The Economic Forum produced a very comfortable, middle-of-the-road outlook for the U.S. economy in 1986. A careful perusal of the discussion, however, reveals many important dimensions of fragility and vulnerability.

The numerical forecasts (table, page 4) show reassuringly favorable expectations for continued steady expansion and moderate inflation. The median forecast calls for a bit over 3-percent growth in economic activity, about a 4-percent climb in the general price level, profits advancing 7 percent, and interest rates flat. In many ways this is a rather happy outcome. Just as Goldilocks found a porridge that was not too hot and not too cold but was *just right*, so do we foresee an economy with enough heat to reduce unemployment slightly, but not enough to trigger an inflationary blow-out.

As always, the average projections hide some marked differences among the individual forecasts. At the low end of the outlook, a 2-percent advance during 1986 would be pretty sluggish. But at the top end, 4½-percent growth would make for a fairly lively economy, with better profits and modest additional pressures on inflation and interest rates. As these forecast surveys go, however, the range of views surrounding the consensus is fairly tight.

The continuing expansion in economic activity is being fueled by moderate advances in every major sector, rather than by just one or two powerful components pulling the rest along. In the household sector, for example, Allen Sinai noted that: "Consumers can no longer be the driving force of economic expansion." Nevertheless, they will continue to pull their weight. The automobile industry, after selling almost 11 million cars in 1985, is bound to see a retrenchment. But if 10.5 million cars are sold next year, as we estimate, 1986 will still be a very good year. Overall, consumer outlays should continue on the upgrade. Spendable income will rise further in 1986 and, with consumer psychology still favorable, retail sales won't be far behind. The public, Amitai Etzioni reported, is in an unusually good mood and, while that normally doesn't last too long, it supports the outlook while it does last.

Prospects for home construction are fair. New housing permits have been rising but at today's mortgage-interest rates, Lyle Gramley pointed out, there is little basis for anticipating a marked improvement in housing production. Tighter standards by mortgage bankers will limit further gains, and 1986 should see about the same number of new starts as 1985—an estimated 1.75 million units.

Business capital formation is expected to support—but not lead—the economy in 1986, with an advance of about 4 percent. The big stories in the investment sector, however, are not in the totals but in their composition. One dramatic shift in the industry is the explosive advance of computers and related "high-tech" equipment, which now account for 49 percent of total capital equipment spending—up from 27 percent just



Edgar R. Fiedler

Many frailties undermining the comfort.

10 years ago. In 1986, computers and similar equipment should again account for the lion's share of the overall advance in capital goods outlays.

A second startling change is seen in the inroads of foreign competition. Since 1980, exports of capital goods have dropped from 27 percent of U.S. shipments to about 20 percent, while imports have climbed from 14 percent of U.S. purchases to 25 percent. As a result, virtually all of the 25 percent gain in U.S. capital goods purchases has been lost to foreign sources. In 1986, although the "high-tech" manufacturers should do well, other U.S. producers are again likely to find it tough to hold their own.

These generally favorable prospects, plus further gains in defense and state and local government spending, add up to something like a 3-percent uptrend for the economy as a whole. Thus, with inflation holding at an unmenacing level, and unemployment inching downward, the economic picture for 1986 looks reasonably bright.

The Uncertainties

What these innocent numbers do not reveal, however, are the many anxieties and qualifications that accompany the forecasts. One of the uncertainties within the economy is the viability of the debt structure. In general, members of the Forum do not feel the consumer-debt burden threatens serious problems, at least not until there is trouble on the job front. Little comfort is taken, however, from debt conditions in agriculture and the developing countries. A second source of concern is the two-track pattern of the economy, with those industries subject to intense foreign competition from the burden of the high dollar (mostly in manufacturing, mining and agriculture) being bruised rather badly, while construction and services are doing quite nicely. Until the dollar falls a good bit farther, this two-track pattern will continue.

Still other worries arise from the international side. Slow growth abroad continues to put a drag on expansion here at home. A more dramatic possibility would be a loss of appe-

THE FORUM CONSENSUS Results of a Pre-Meeting Outlook Survey

	Actual 1984	Estimated 1985	Fourth Quarter 1985	Projected	
				1986	
				Median	Range
Economic Growth (Real GNP, percent change)	5.7	2.1	3.5	3.2	2.0 to 4.5
Inflation Rate GNP Deflator, percent change)	3.6	3.6	3.3	4.2	3.1 to 4.9
Corporate Profits (After taxes, percent change)	0	- 2	3	7	-5 to 20
Unemployment Rate (Percent, average during fourth quarter)	7.2	7.0	7.0	6.8	6.4 to 7.5
Commercial Bank Prime Rate (Percent, average during fourth quarter)	11¾	9½	9½	9½	8.5 to 12
	Actual FY 1985		Projected		
			FY 1986	FY 1987	
Federal Budget Deficit (Billions of dollars)	212		192	182	

Note: These forecasts incorporate submission by Forum participants in early November, and are based on data available at the time. For growth, inflation and profits, the annual forecasts are the percent change over the four quarters of the year, i.e., from 1985 IV to 1986 IV; the forecasts for the fourth quarter of 1985 are at seasonally adjusted annual rates.

tite by foreign investors for U.S. securities, which could bring on an upsurge in interest rates that would turn the expansion into a 97-pound weakling. The accompanying sharp drop in the exchange value of the dollar would have the opposite effect on prices, that is, it would turn the near-calm of today into an inflationary windstorm. Finally, there is a more subtle anxiety about the increasing dissatisfaction and political resentment about the United States that is being felt throughout the world. In general, our military and economic might is respected, but foreigners are not at all sure we know how to use our power wisely.

A third set of concerns centers around government policies. Gary Wenglowski expressed doubts that anyone really knows how to measure the thrust of policy in a world of floating exchange rates. If other major nations have fixed their fiscal policies at too restrictive a setting, he worried, perhaps our deficit should not be reduced without international coordination. Protectionism is also a source of nervousness, although most members of the Forum feel that, one way or another, the United States will avoid enacting major protectionist legislation this year or next.

The greatest uncertainty surrounds the Gramm-Rudman-Hollings initiative to reduce the deficit, now being debated in Congress. This legislation has a political steamroller behind it, and is likely to become law in one form or another. If so, the teeth built into this law are going to bite painfully.

In its mildest form so far, the bill would require \$20 billion more in spending cuts than all cuts previously proposed. Since even the earlier proposals far exceeded the public's taste for program reductions, when (and if) the new legislation takes hold, the complaints would come from every point on the political spectrum. Indeed, the screams would be deafening and overwhelming.

The ensuing political brouhaha would be a beaut! How it might get sorted out is anybody's guess. The Forum's guess is that in the end the leadership of the House and Senate would negotiate a compromise with the President that would include (1) a relaxation of the deficit target, (2) moderate cuts in both military and social spending, and (3) a tax increase, perhaps a "business transfer tax" (a form of sales tax). But whatever comes out of Gramm-Rudman-Hollings, it is sure to include plenty of political, economic and financial turbulence.

A further uncertainty about policy is the future of tax reform. The chances of a major restructuring of the tax system fade a little more with each passing day, partly from all the specific pressures lined up against the idea and partly from the fight over deficit reduction. President Reagan's trips around the country were unsuccessful in generating a groundswell of support for his package of reform. Some type of "tax reform"—featuring a stiff minimum tax on both individuals and corporations—will be enacted; that much must happen for image and face-saving reasons. But the final bill will not

represent significant reform relative to what has been discussed throughout 1985.

Conclusions

What does all this mean for the financial markets? Prices of both stocks and bonds have been rising all year, but without bringing peace of mind to the financial community. Indeed, the rising markets appear to have produced only rising anxiety: anxiety about excessive leverage, about the wild fluctuations that are now so common for individual issues, about the many new capital-market instruments not yet tested by adversity, about a sharp drop in the dollar, about too much strength developing in the economy, and about the unknown impact of

Gramm-Rudman-Hollings. All are perceived as serious threats to financial equanimity. "The word from the equity markets is *unease*," Bob Wade told us.

But while all these uncertainties, some of which are of alarming proportions, are present, they remain possibilities rather than probabilities. Those that do materialize could turn out to be less damaging than advertised. Furthermore, few if any of these threats appear to be imminent. In the final analysis, then, economic prospects for 1986 do, in fact, look quite agreeable. Equally important, however, are the many frailties in the economy, which work against robust expansion and which, as 1986 unfolds, could seriously undermine the comfort people feel about the outlook.

Political and Social Trends

Amitai Etzioni

And now, watch out for the BTT! The BTT? Yes, BTT, the son of VAT! The sociopolitical climate may be right next year for the public discussion and, possibly, the enactment of a business transfer tax. The BTT, which has been crafted by Senator William V. Roth, would be imposed on all domestic business transactions, with special provisions to exclude "essential items" (food, medicine) and to cover imports. At a 10-percent level, BTT is estimated to kick in \$78 billion (assuming a FICA and federal income-tax "credit") annually to the Treasury.

BTT's star may rise for some obvious and some not-so-obvious reasons. Most obviously, it would serve to reduce the still gigantic deficits, as the taste for cutting social programs or defense is being exhausted in the country and in Congress. The fact that BTT also serves as a tax on imports adds to its appeal.

Less obviously, the tax-reform bill, which is widely expected to be enacted in some form, will shift part of the burden of taxation from individuals to corporations. (While the proportion of total revenues garnered from corporations will remain at an historically low point, and while tax rates for both individuals and corporations are expected to be lowered, corporations will lose more from various other changes in the code and, hence, their net tax payments are expected to rise.) BTT, a tax that sounds as if it is imposed on businesses but actually is a sort of sales tax, will work to tilt the system back in the direction it was leaning before the 1985 push for tax reform.

The Social Setting

The public mood is very favorable, but may be riding for a fall akin to consumer spending and confidence. Precisely

Amitai Etzioni

Watch out for BTT, son of VAT!



because the level is so high, it is unlikely to be sustained. Also, the President's teflon—his continued high popularity, even when events don't go his way—although far from worn out, shows a few cracks.

The satisfaction of Americans with their personal life continues to be very high (about 80 percent are satisfied). More important, their satisfaction with the state of the nation is at about the 50-percent mark, compared to 35 percent in August, 1983, and 19 percent in November, 1979. There is a general return to commitment to institutions, authority and traditional values. More people—including the young—identify themselves as conservatives; marriage is on the rise; standards in schools and colleges—even SAT scores—are higher; patriotism is "in." There is a sense that the government is neglecting social programs, but there is no alarm about it. Corporate and personal giving are up.

Underneath it all, however, there is a surprisingly high sense of alienation, of general unfocused disaffection. The President is still popular *personally*, but his policies are not. There is some sense that his agenda is no longer dominant; that,

rather than leading, he has grown reactive—for example, the change in policy toward South Africa; the amendment to balance the budget by 1991. His intense campaign to evoke active public support for tax reform failed.

Barring a major international crisis or failing health of the President, where the political-social trends go from here depends on the economy. If a recession enters the scene in 1986,

it may reinforce weakening signs in the recent wave of confidence and reconstruction; it would come when political-social waves are cresting, not rising. Alternatively, if economic growth is renewed with vigor, trends of political and social optimism may be extended. Watch how the Republicans do in the 1986 elections for a major clue to where the political-social trends are headed.

The International Political Environment

Paul H. Kreisberg

The international political environment for the United States and for U.S. business is gradually deteriorating. It is not yet really serious, but could easily become so. U.S. policy initiatives could affect this trend in some sectors, but there is no assurance that the overall environment is susceptible to real change in the short to medium term. The three principal variables are:

- The possibility of a new wave of protectionism in the United States that would hurt many of our closest friends around the world, intensify tensions between and among developed and developing states, complicate the handling of international debt issues, and aggravate political unrest in many countries.

- High unemployment in Western Europe, the difficult prospects for reaching accommodation with the European Community on a wide range of trade issues, and underlying unease in many European countries on a variety of security issues, both conventional and nuclear, could contribute to electoral shifts in a number of countries in 1986 toward either labor-socialist governments or more nationalistic ones in the United Kingdom, West Germany, and France. While these would not alter basic alliance relationships, they could raise new problems for the United States in coordinating policies toward the communist states and on global economic issues.

- Uncertainty about U.S.-Soviet relations—and whether these will lead toward relaxation of tensions or heightening of the global arms competition and of regional tension around East-West issues—is particularly high in Europe and elsewhere. Despite recent hints that both sides may be moving closer to a workable negotiating posture for the Gorbachev-Reagan Summit late in November, it is doubtful that the results will satisfy anyone for long and, indeed, they could increase pressures on the United States from a wide variety of directions. For example, deployment of cruise missiles will not be completed until 1989 and allied participation in, and support for, the Strategic Defense Initiative remains uncertain; both of these could become sources of increasing alliance tension. Signs of progress in East-West relations could lead to new European efforts to broaden links with the Soviets and Eastern Europe and to resistance to U.S. urging of greater defense ex-

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Concern about how the United States uses its power.



penditures for new high-technology conventional weapons. Lack of such progress, on the other hand, will intensify debate about the wisdom of U.S. policies not only in Europe—where greater independence of policy actions may be a consequence—but around the world since, rightly or wrongly, the United States is seen as the party most susceptible to external political pressure and the initiator of the current phase of the arms race.

Concerns Abroad

How the United States resolves its own structural domestic economic dilemmas will affect the economic and political environment in the most fundamental ways. No one questions the reality of U.S. economic and military power. The dimensions of the defense build-up are universally recognized despite considerable unease over its efficiency and over *how* that power may be used. And the intensity with which the U.S. economy affects the entire international economic order both in monetary and trade terms has been reemphasized again for all countries in the last two years.

But for the first time since World War II (including the 1971 monetary and trade “shocks”), there seems to be widespread international uncertainty that the United States knows how to deal with its own macroeconomic problems. The Seoul World Bank and IMF meeting and communique in October, 1985, helped ease some of these concerns. So did the ministerial decision on currency intervention by treasury and central bank officials a few days earlier. Nevertheless, U.S. budget, debt,

trade and tax debates are the subject of enormous international economic and political concern. The longer they go on without resolution, the greater will be foreign worries over whether the United States *can* resolve them, or at least resolve them without devastating damage to others abroad.

A number of countries with severe debt problems also are fragile democracies—for example, Brazil, Argentina, Mexico and The Philippines. These face economic and political crises if U.S. economic decisions trend toward protectionism, higher interest rates, and either inflation or deflation. The urge to find some external source to blame for domestic disasters will be intense, and none of these states will long delay in singling out the United States as responsible. Thus, U.S. political and security interests could be severely impaired.

Some other countries that have grown accustomed to high growth rates and that are heavily dependent both on continuing domestic industrial growth and on exports to the United States—including most of the newly industrialized countries of Asia—could confront serious internal economic and political challenges, if those growth rates remain depressed. Expectations of technology transfers and of investments in a number of these countries may also be disappointed. Resentment of the United States could surge throughout the Asian region, including China and Japan, and regional competition for both markets and investments could disrupt good intraregional relations as well as economic development.

The stability of U.S.-Japan relations is based on deep national interests on both sides, but it is abundantly evident that strains on the relationship are increasing and its tensile strength is not infinite. Even though the Japanese have now moved in some major ways to respond to U.S. political and economic concerns, Japanese reforms may be insufficient to meet U.S. political needs. The U.S.-Chinese relationship also remains more fragile than the constant flow of visitors, the rhetoric of friendship (more evident on the U.S. side than the Chinese), and the growth of trade in the last few years (slowing in 1985) might imply. There would be few more powerful shocks to the international political and economic environment than a broad sense in Asia that the United States was insensitive to the interests of the states of this region.

In a totally different respect, South Africa raises major questions of race and politics, not only throughout the developing world but within the United States and the United Kingdom. Violent racial conflict in South Africa has become an increasingly threatening prospect in 1985, and could easily have consequences going far beyond formal government or international economic relations with that area to affect civic order, race relations, and corporate policies in many countries.

The overall international political scene is one that should be cause for some concern and for the most careful monitoring by anyone with interests in international political and economic relationships.

An Accelerating Expansion

Gary Wenglowksi

Some signs of a significant acceleration of economic growth emerged during October—the employment report, the leading indicators, and some anecdotal evidence from our industry analysts. The tone of the published economic data, however, seems to be shifting almost monthly, whipsawing many forecasters. As a result, more durable projections are likely to be based on assessments of the underlying degree of stimulus to business from fiscal and monetary policies and of conditions in the major sectors of the economy.

The federal deficit (unified budget) increased by \$27 billion between fiscal 1984 and the fiscal year ending last September. The cyclically adjusted (or structural) deficit also increased by around \$30 billion. That compares with \$52-billion and \$34-billion increases in fiscal 1983 and 1984, respectively. Therefore, the traditional gauge of fiscal policy's stimulus to growth of demand—the increase in the cyclically adjusted deficit—has been falling.

More importantly, restrictive fiscal policies in major foreign economies are offsetting some of the stimulus to domestic GNP growth from U.S. policies. Slower economic growth abroad reduces the expansion of U.S. exports. In addition,

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Forecast above the consensus.



floating foreign-exchange rates heighten the attention that must be paid to economic policies abroad in evaluating the *net* stimulus to U.S. growth from domestic fiscal and monetary actions. Relatively restrictive foreign fiscal policies can contribute to the incentives for capital to move to the United States by dampening investment opportunities abroad. The resulting upward pressure on the dollar exchange rate increases the drag of a rising foreign-trade deficit on U.S. economic growth.

Foreign fiscal policies appear to be moving toward stimulus very slowly. The actions taken in Japan to stimulate domestic demand have generally been viewed as of modest magnitude. Continued record unemployment in Europe has yet to result in strongly expansionary fiscal policies. The possible enactment of the Gramm-Rudman-Hollings Bill would increase the need for more expansionary policies outside the United States. That bill, if followed to the letter, would compel declining U.S. budget deficits.

Foreign considerations also complicate an assessment of U.S. monetary policy. For the Federal Reserve to offset the negative impact of a rising foreign-trade deficit on U.S. growth, it must allow interest rates to fall sufficiently to create a compensating acceleration of domestic demand. However, myriad new uncertainties over the magnitude of the trade deficit's further deterioration, prospects for the dollar, and the dollar's effect on future inflation and foreign trade are added to the usual questions of how the domestic sectors will respond to declining interest rates. The slowdown in the economy since mid-1984 and the failure of real growth to accelerate to the 4-percent area the Fed predicted for the second half of this year suggest that the monetary authorities did not allow interest rates to fall rapidly enough during the past 15 months to compensate fully for the foreign-trade drag. Although some of the most recent changes in indicators of Fed policy raise questions, monetary policy, on balance, appears quite expansive.

The Outlook by Sectors

A more complete assessment of the outlook should also include an evaluation of conditions in the major sectors of the economy, searching for evidence of imbalances, which could trip economic growth, and for signs of the degree of policy stimulus to private spending decisions. The low personal saving rate and rapid expansion of consumer debt top most current lists of potential imbalances. Our latest analysis, however, confirms our earlier conclusion on this issue—U.S. consumers are not seriously overburdened with debt. Consumer debt outstanding and debt service for the average family are well below previous peaks after several factors are considered—the relatively rapid growth of the heavy-debt-using 25 to 44 age group, lengthening of loan maturities, tax deductibility of interest payments, convenience credit-card use. Although the personal saving rate should move back up to the 3-percent area (from less than 2 percent in September) as auto sales return

to a more normal pace, downward pressure on saving is likely to continue as long as the Federal Reserve seeks to offset the foreign drag on U.S. economic growth with lower U.S. interest rates.

Business fixed investment fell almost 5 percent (annual rate) last quarter in real terms: the first significant decline since 1982. A rebound is likely this quarter, based on the strong capital equipment orders and shipments and nonresidential construction contracts of recent months. These quarterly swings are likely to average out to only modest net increases in real capital spending until overall U.S. economic growth has accelerated. The near-term increases in business investment appear capped by lower capacity-utilization rates, while their downside is limited by relatively high business cash flows.

Inventory accumulation should not add significantly to growth until some time in the first half of next year. While inventory liquidation occurred last quarter for the first time since 1983, its composition does not suggest an imminent reversal and boost to the economy. All of last quarter's liquidation was in automobiles, reflecting the stimulus to sales from the temporary, promotional loan rates. Nonauto inventories continued to increase.

The stimulus to growth from the declining dollar is also unlikely to occur before the first half of next year. The negative effect on growth from rising imports is likely to continue to be severe through the second half of 1985, but the first signs of its eventual diminution have recently appeared in reports of price increases on imported goods due to the falling dollar. Therefore, despite the stirring in some of the latest economic statistics, the near-term outlook is for only modest acceleration above the slow growth of the first half. We continue to project a 2 to 3 percent range for economic growth in the second half of this year—with a possible downward revision of the government's 3.3 percent preliminary real GNP growth for last quarter. This second-half estimate remains weaker than the latest consensus of forecasts.

We continue to believe that a significant acceleration of growth will begin in the first half. The primary cause will be a reduced drag on the economy from the trade deficit. Its effect on the manufacturing sector should be amplified by an upturn in the inventory cycle and spread through the rest of the economy by the pickup in income growth. Our estimate of real GNP growth between the end of 1985 and the end of 1986 is still in the 4 to 5 percent range, above the consensus forecast.

A Long-Wave Hypothesis for the United States

Albert T. Sommers

In its original form, posing mechanistic periodicity and inevitability as characteristics of a long wave, the 50-year "Kondratieff" cycle makes very little sense logically. But this should not rule out consideration of a real, causal, logical long-wave component in economic history. The search for such a wave should begin with the identification of a set of highly abnormal, extreme conditions carrying a powerful net balance of stimulus and going far beyond anything that would be contemplated by discretionary economic policy in ordinary times. The long-wave thesis should thus identify the energy created in the initial abnormal state, and seek to measure its rate of exhaustion.

Conditions prevailing almost exactly forty years ago at the end of World War II qualify spectacularly as a time of gross discordance in world economic conditions, containing a huge volume of static economic energy—an unprecedented voltage accumulated over ten years of worldwide depression followed by five years of very nearly total war. Private debt and the capital stock had shriveled, whereas unexploited technology and liquidity had increased enormously. To these necessary and sufficient conditions for a "big bang"—and the onset of a long wave—should be added the fact that the United States emerged from World War II in a condition of economic and technological dominance unsurpassed in the history of any nation anywhere.

In short, there has never been a better candidate for the necessary accumulation of violent energy than the fifteen years ending with peace in 1945. The end of World War II marked a spectacular new dawn for the U.S. economy.

This is a solid case for an explosion capable of generating a long wave. But the empirical study of its course through time should not be expected to reveal a high degree of regularity or periodicity, or a clear continuity of evidence. What we should seek, instead, is evidence of progressive exhaustion of the strengths out of which the wave originated. And what we find is that a coherent, comprehensible course of declining energy is visible in all of the fundamental components of the wave. In fact, the exhaustion in so many (not necessarily all) of these areas is so far advanced as to suggest that the United States is already on the leeward side of the wave, and is now struggling against a withdrawing underlying tide.

The private debt burden would now appear to be mature, by almost any criterion. Ratios of debt to the income flows that must service them are high (and still rising) throughout the private sector. Defaults and bankruptcies are rising. Federal debt is growing rapidly—faster than the growth of aggregate debt, so that the share of federal debt in the total is rising, as it characteristically does during periods of weak business conditions. Further, the end of inflation is making the debt burden more onerous.

The current condition of economic policy carries the same



Albert T. Sommers

The economy is struggling against a withdrawing tide.

suggestion of exhaustion. In 1985, a huge budget deficit has been accompanied by accommodative monetary policy—the policy posture normally adopted in periods of serious recession. The system's sluggish and uncertain growth in response to this massive stimulus is further testimony to the withdrawing underlying tide in the system.

Finally, the international position of the United States, which was one of its most extraordinary strengths at the start of the long wave, has reversed with a vengeance. The U.S. trade position has deteriorated with respect to virtually all of its markets. Its technology is available around the world, where it is generally associated with labor costs that are a fraction of the labor-cost level built into the United States system through thirty years of an ascendant long wave.

These changes—in debt position, in liquidity, in inflation, in the response to policy stimulus, in international trade and income flows—can be viewed as deteriorations in individual areas. But their interconnections are substantial. Together, as they would be viewed in a long-wave hypothesis, they describe progressive involution of virtually all of the conditions on which the birth of the long wave rested. Their deterioration has reached a point that suggests that the cumulation of the wave, and its reversal, are now at least a few years in the past, and that the system is now already well into a struggle to offset a cumulative drain on its energies.

Policy Implications

The proper conduct of policy for now and in the future should take conscious and deliberate account of the vulnerabilities suggested by the long-wave hypothesis. The hypothesis carries the suggestion of large dangers, requiring substantial defensive treatment. The prescriptions that it suggests are different from the standard prescriptions that would be arrived at apart from the hypothesis. The hypothesis calls for a careful, progressive, even slow and measured effort at reduction of the U.S. federal deficit. What is ignored in arguments for determined and rapid reduction in the deficit is the

fact that a deficit reduction is inherently deflationary; the hypothesis suggests that this is no time to undertake radical deflationary surgery on the budget.

Likewise the thesis warns urgently against restrictive monetary policy—here or in any other major country. At the end of the great wave, the world gives the impression of requiring reflation if the pyramid of debt is not to deteriorate at a cumulative rate. The thesis argues, further, against general protectionism and, beyond that, for effective international cooperation in the coordination of economic policies, in trade, in the financing of international lending organizations, in the stabilization of currency-exchange markets. Far more than ever before, the world is joined in its trade, currency and financial markets; going it alone carries major risks for all.

In conclusion, the documentation for the long wave, and

the proposition that its present condition represents a time of troubles, is incomplete, but respectable. It is not strong enough to offer unequivocal prescription; but it is certainly strong enough to require serious consideration. By its nature, a long-wave hypothesis is conjectural, and inferential. A determination of its present position is bound to be partly an act of intuition and insight. The thesis advanced here—that a long wave was born forty years ago in an explosion of fifteen years of accumulated energies, and that those energies have been largely consumed—is a usable thesis, carrying an impressive body of implications for private business and for public policy. To ignore it is to set aside a powerful conceptual structure for ordering the history of recent years, and placing the seemingly paradoxical conditions of the present into a revealing perspective.

Prices, Costs, Productivity and Profits

Geoffrey H. Moore

Since the 1984-85 growth recession appears to be losing its grip on the economy and expansion seems likely to continue for a while, it is worth considering what previous long-lived expansions have to tell us about prospects for inflation. Between 1949 and 1980, there were three business-cycle expansions that lasted more than 40 months: in 1949-1953, 1961-1969, and 1975-1980. Since the current expansion has already lasted 36 months, the three long-lived expansions are—hopefully—relevant to the current outlook. We have, therefore, constructed recovery patterns that compare the current expansion to date with the average of the three longer expansions during their first 48 months.

Recent price inflation has been tracking the previous average pattern very closely (see chart, page 11). The rate for the consumer price index, measured by a method that smoothes away most of the erratic movements, was 3.0 percent in September, which compares to an average rate of 3.5 percent at this point in the three long expansions. In the average pattern there was a little upward drift in the fourth year, and a corresponding rise now would bring the rate up to about 4 percent by the end of 1986.

The leading index of inflation, which has had both a large upswing and a smaller downswing in this recovery (which led the inflation rate nowhere) now seems to be getting back in line both with its average pattern and with the inflation rate. Its errant behavior against inflation was due to some unusual shifts in the relations between its three components and subsequent inflation. The rapid rise in the percentage employed to an all-time high early this year did not have its usual consequence: Wage inflation remained quiescent. The rapid rise and fall of industrial materials prices did not have its usual conse-

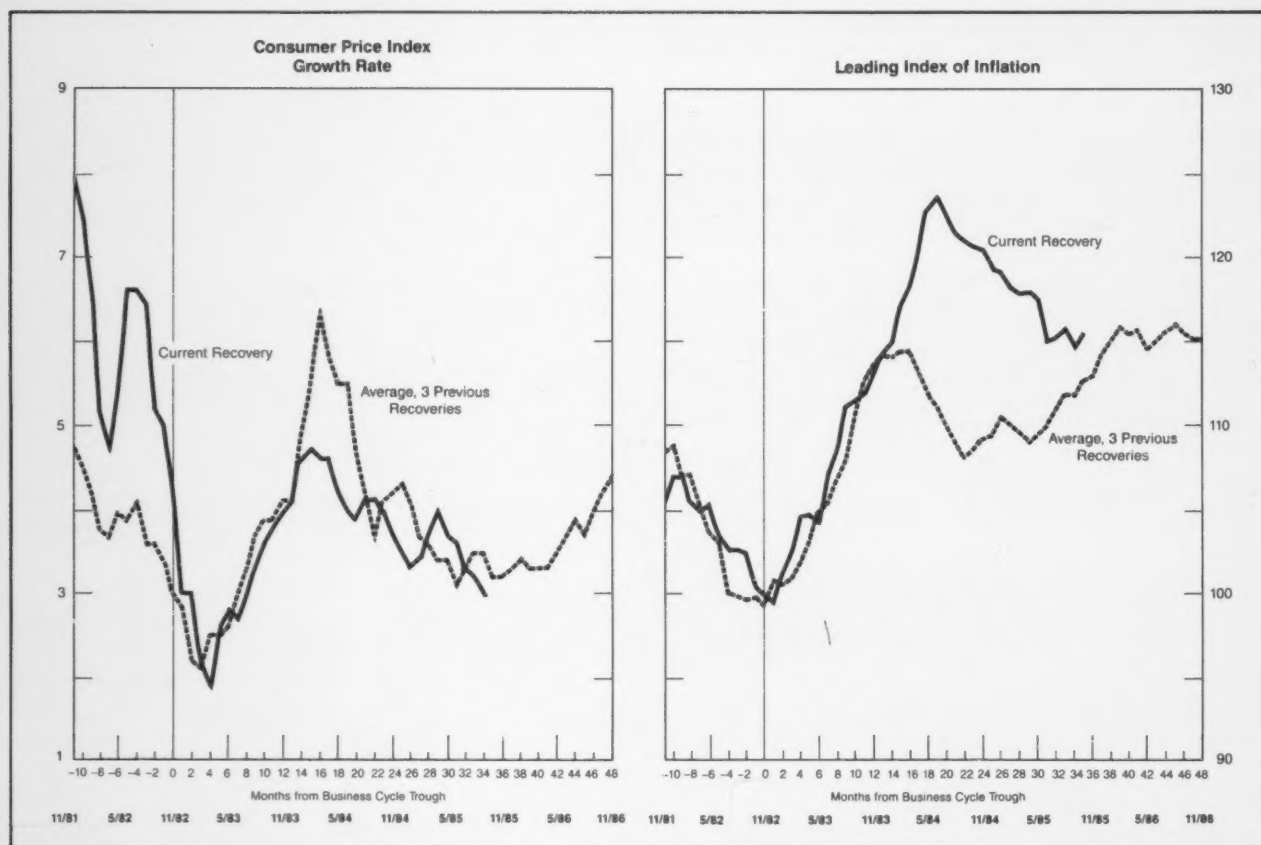
quence: Commodity-price inflation at the finished goods level scarcely budged. The enormous rise in total debt, which has subsided but by no means disappeared, did not have its usual consequence: The general price level advanced sedately.

Why did inflation remain so subdued this time around? Much of it probably can be blamed on the rise in the dollar exchange rate, which kept import prices down and worsened the competitive position of our basic industries, including farming. Deregulation was another factor intensifying competition and reducing prices. The weakening of OPEC produced a sort of reverse oil shock, reducing energy prices. Labor unions have lost strength, both absolutely and relatively, partly because of the growth of the service industries. Widespread indexing of wages, social-security payments, and other contracts means that a declining rate of inflation now has more feedback effect. The reversal of inflationary expectations, built up during the 1970's, also has feedback effects on wage demands, interest rates and the cost of financing, inventory accumulation, and advance buying.



Geoffrey H. Moore

A modest acceleration of inflation.



A Modest Speed-Up

There is no lack of unusual developments to point to, but the fact remains that the leading inflation index and each of its components is now higher than when the recovery began. My view is that, because of the factors cited, its lead time against inflation has lengthened, but that the underlying relationship remains. A modest rise in the inflation rate during 1986 to 4 or 5 percent would be consistent with that view.

This prospect is supported by the upward drift in unit labor costs, which increased in the third quarter at a 3.5 percent rate, exactly the same as in selling prices. The average gain in costs during the three previous expansions at this stage was also 3.5 percent, and that average shows an upward drift to about 4 percent during the fourth year.

I would expect productivity to pick up a bit more as we leave the effects of the growth recession behind. The third-quarter rate was only 0.5 percent, as we calculate it. That could easily get back to the 2-percent level later this year and in 1986, which would put it in line with the average pattern of previous four-year-old recoveries.

Rates of gain in hourly compensation, which include both earnings and fringe benefits, have been in the neighborhood of 4 percent for the past two years. This is an unusually subdued rate, even relative to the reduced rate of gain in prices. Hence, real wages have shown virtually no gain—in contrast

to previous experience when the average gain during past recoveries has been about 2 percent. However, there has been a slight upward drift in the rate of gain of real wages since the fourth quarter of 1983, and I would not be surprised to see this continue in 1986, especially if productivity grows faster.

Getting to the bottom line, profitability, we need to compare the rates of gain in prices with those in costs. Labor costs are not total costs, but they do comprise a large and dynamic share of the total. During the early stages of most recoveries, including this one, selling prices rise more rapidly than unit labor costs. Indeed, the differential in favor of prices increases for a year or so, which means that profit margins recover rapidly from the depressed level to which they fell during the recession. Then costs begin to catch up with prices; the improvement in margins slows and finally stops. That is precisely what happened in 1983, 1984, and 1985.

According to the Commerce Department's ratio of corporate profits after taxes to corporate domestic income, profit margins have made a dramatic recovery since 1982, and are now back to 10 percent, their average level in preceding recoveries. This measure pertains to profits after inventory valuation and capital consumption adjustments. It excludes inventory profits or losses by valuing inventories at replacement costs, and it excludes the effect of accelerated depreciation as permitted by the tax code. These adjustments have

made an enormous difference in the level of profits in recent years. In the second quarter, the margin would have been 6 percent without the adjustments, instead of 10 percent. Moreover, the improvement during this recovery would have been much smaller without the adjustment, since both figures were close to 5 percent when the recovery began. In general, I believe the adjusted profit figures are more realistic as well as more consistent with the price/cost relationships we have been discussing.

What happens next year depends on whether prices continue to keep pace with costs or whether they go further ahead

or fall behind. I would say that both are likely to accelerate moderately next year into the 4- to 5-percent range. But the matter should be closely watched: It is an early sign of recession when costs begin to climb significantly faster than prices. At the moment, the race is neck and neck.

To sum up, looking ahead into 1986 I see: (1) a modest advance in the inflation rate into the 4- to 5-percent range, matched by a similar rise in unit labor costs; (2) a faster rise in wages, up to the 6 percent area; (3) recovery in productivity growth, to around 2 percent; and (4) profit margins holding at their recent levels.

Prospects for Tax Reform and Deficit Reduction

J. Gregory Ballentine

Dramatic revenue-neutral tax reform appears likely to evolve into more modest revenue-raising reform, and that is probably a good development. Not only are more tax revenues needed, but the trend in revenue-neutral tax-reform proposals is toward a sharp increase in the overall tax rate on business capital income. The damage done by such a shift in the tax burden may outweigh the advantages reform can bring in achieving a more equal tax rate among alternative business investments.

Revenue-neutral reform of the *personal* income tax can only achieve a sharp decline in personal income-tax rates by eliminating, or sharply curtailing, some itemized deductions. Doing so, however, raises an inescapable dilemma: Only about 60 to 65 percent of middle-income taxpayers itemize. If personal tax rates are lowered and the revenue loss is offset by a reduction in allowable itemized deductions, then most middle-income itemizers must pay more taxes, while middle-income non-itemizers will pay less. This, in turn, would mean that virtually every homeowner earning between \$20,000 and \$40,000 would pay more taxes. Obviously, the political system will not allow that. As a result, before any politically attractive revenue-losing provisions are even considered, the basic structure of current reform proposals dictates an overall reduction in personal income taxes and a sharp increase in corporate taxes.

The reform proposal before the House Ways and Means Committee embraces and enlarges this shift to higher corporate taxes. Further, the trend in the Committee seems likely to expand the shift even more. If such reform actually passes, we can expect a dramatic increase in the tax burden on business capital income with a corresponding decline in the tax burden on labor income. (Wages and salaries comprise about 85 percent of all "adjusted gross income.")

While this shift may reduce net saving in the United States, proponents of the recent reform proposals point out that re-

J. Gregory Ballentine

Substituting a political crisis for an economic crisis.



form will result in a more efficient use of U.S. saving by equalizing tax rates across business investments. It is certainly true that the reform proposals may generate efficiency gains by improving the allocation of investment among businesses, but they may also generate efficiency losses by worsening the allocation of savings between business and nonbusiness investment. The wide differences in effective tax rates across business investments has attracted considerable attention and is a legitimate issue for reform. Unfortunately, proponents of reform have seemingly ignored the equally important problem of differences in tax rates between business and nonbusiness investments.

More than 40 percent of the depreciable U.S. capital stock is completely exempt from income taxes, at both the personal and corporate level. That capital is not business capital; it is consumer durables, including owner-occupied housing. Political reality dictates the continued tax exemption of such capital. As a result, tax reform that seeks to reduce disparities in tax rates across investments should seek to lower the tax rate on business capital as a whole (while equalizing tax rates among different business investments) in order to reduce the

huge tax penalty on business savings compared to nonbusiness savings. Recent proposals do not do this. Indeed, they tend to return our tax system to the situation of the late 1970's when the disparity between the tax treatment of consumer durables and that of business investment widened, tending to expand nonbusiness investment at the expense of productivity-enhancing business investments.

If a tax-reform bill passes that raises the tax rate on business capital income, the damage being done by the deficit will be aggravated. During the period 1980-1985, total U.S. saving (net of the deficit and net of depreciation) has been less than 4 percent of net national product. In contrast, during the 1950's, the savings rate was about 7.7 percent; it was 8.0 percent in the 1960's, and 7.0 percent in the 1970's. The major reason for this decline is the increased federal deficit. Now is possibly the worst time to redistribute the burden of taxation so as to fall more heavily on business savings, while leaving total revenues unchanged.

Efforts to Reduce the Deficit

It appears that dramatic tax reform will not be enacted, however. Instead, the passage of some version of the Gramm-Rudman-Hollings deficit-reduction proposal will likely lead to a 1986 tax increase (which will, of course, be labeled as tax reform). While that tax increase will probably fall heavily on business investment, nonetheless, if it lowers the deficit, its net effect will be to encourage net business saving.

The Gramm-Rudman-Hollings proposal sets targets for the deficit for 1987 through 1991 that begin at \$144 billion in fiscal 1987 and decline by \$36 billion a year to zero in 1991. Unlike previous statements of congressional intent to balance the budget, this proposal has an enforcement mechanism: If the targets are not met, the President is directed to make uniform cuts in a subset of government programs that excludes social security, many defense contracts, and certain other programs.

The key point about Gramm-Rudman-Hollings is that the results of the enforcement mechanism are likely to be so unpalatable to both the White House and Congress that they will be forced to achieve some compromise deficit-cutting package next year. My rough calculations suggest that, even assuming the Administration repeats all of its fiscal 1986 proposals that have not been enacted, it will still face deficits well above the GRH target for fiscal 1987, and even more above the targets for later years. Congress will almost certainly be unwilling to enact those Administration proposals, much less the deeper cuts the Administration may propose to meet the targets. As a result, the specter of the enforcement mechanism will have to be faced.

The White House will likely find the across-the-board cuts stipulated by the enforcement mechanism to be unacceptable because deep cuts in certain segments of military spending will be required. Congress will find across-the-board cuts unacceptable for many reasons, including the fact that many domestic programs that have most of their spending based on prior year policies (e.g., guaranteed student loans and some HUD programs) will have new activity dramatically curtailed by even modest outlay reductions.

Many persons have speculated that the deficit will not be dealt with finally until Congress perceives the deficit as causing an economic crisis. The Gramm-Rudman-Hollings proposal should be viewed as substituting a political crisis for an economic crisis. It may well force everyone to the bargaining table to negotiate plans similar to those agreed to in 1982 and 1984. Those plans took significant action against the deficit through a combination of tax increases, domestic-spending reductions, and defense-spending restraint. Even if the resulting tax increases fall on business investment, the net effect of such a deficit-reduction package can be a significant increase in net U.S. saving. Thus, replacing current tax-reform proposals with such a package may be a step in the right direction for the capital markets.

Profound Turnaround on the Dollar

Roger M. Kubarych

In September, acting in collaboration with the finance ministries of Japan, Germany, Britain and France, the Reagan Administration announced a major change in international policy toward the dollar. What the Administration said, in effect, was that the international currency markets had gotten it wrong. The dollar had climbed too high, and had stayed too high too long. Accordingly, a blend of economic policy changes, buttressed by massive central bank intervention in the foreign-exchange markets, was needed to get it right.

For Washington, this agreement marks a profound turnaround in philosophy and approach. Ultimately it will have far-reaching consequences for trade, economic growth, and inflation. The magnitude of the policy shift cannot be minimized. Until September, this Administration had been the resting place for three very different views of the dollar, all of which led to the same policy recommendation—leave the dollar alone.

- View Number 1 was that a strong dollar is basically a good thing, regardless of the short-term damage it does to our industrial competitiveness and our trade deficit. It keeps inflation low. Also, it puts pressure on allegedly slow-moving corporations to become more efficient, to drop lines of business in which comparative advantage had clearly moved offshore, and to manage labor relations better. Perhaps more important, the high value of the dollar is seen as signifying a vote of confidence by foreign investors in the overall thrust not only of U.S. economic policy in the broadest sense, but also of U.S. initiatives in the political and national security areas. As one Japanese banker said, it was the era of the "Star Wars Dollar." The implication of this view: Enjoy the benefits of a strong dollar, do nothing to compromise them, but acquiesce to selected pleas for help by industries most seriously affected (cars, steel, and a few others).

- View Number 2 had a different flavor. It derived from the belief that exchange markets are efficient, and thus it is meaningless to think of the dollar as being overvalued or undervalued: It is wherever the market puts it. Intervention, whether by central banks buying or selling currencies, or by governments imposing restrictions on international capital movements, would be ineffective, at the least, and probably harmful. The implication of this view: Be indifferent to the dollar's movements; do nothing about them: but *don't* offer special help to troubled industries either, because that also distorts the markets.

- View Number 3 reflected an entirely different brand of economic thought—more analytical, less ideological. It held that the culprit is the U.S. budget deficit, which represents a massive drain on the nation's limited home-grown savings. The budget deficit causes high real interest rates, which pull in



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The new policy on the dollar is only the beginning of the treatment.

funds from abroad and make the dollar high. The high dollar, in turn, stimulates imports and discourages exports, which leaves the trade balance in deficit. But that trade deficit is the very source of foreign savings needed to fill the savings gap left by the budget deficit. On this reasoning, the U.S. needs to fix the budget deficit. In the absence of that, the dollar will have to remain strong enough to close the loop. The implication of this view: Do nothing about the dollar directly because it will divert attention away from the real need (to cut the budget deficit) and won't work anyway.

Within the Administration these three views have now been shunted to the side, as growing protectionist pressures—virulent enough, perhaps, to plunge the world into a vicious cycle of new trade restrictions—posed an immediate threat. Thus, doing nothing about the dollar has become more dangerous than acting to deal with the overvaluation.

Coming Full Circle

Accordingly, the Administration has come full circle to the policy view that prevailed before it took office: Markets can and do overshoot seriously. When they do, intervention can be a useful tool to get market psychology back to earth. To be sure, fundamental policy shifts are indispensable. Sooner rather than later, the United States must cut the budget deficit; Europe must expand faster; Japan must import more; the LDC's must be financed so they can again grow at tolerable rates. But until all that transpired, to do nothing about the U.S. trade deficit, which is the same as doing nothing about the dollar, was no longer a viable strategy.

How soon will the results come, and how great will they be? They will come slowly and not dramatically and they will possibly be very disappointing to protectionists, who now are taking a wait-and-see attitude. It is a near certainty, therefore, that the trade issue is not behind us. Only the beginning of the treatment has been prescribed, not the whole cure.

Household Spending and the Expansion

Allen Sinai

In 1986, as has been the case for much of the past few years, consumer spending will be one of the keys to whether the current expansion can be sustained. Since the fourth quarter of 1982, household spending has been a driving force in U.S. economic growth. Sharp rises in disposable income, fueled by the Kemp-Roth tax cuts of October, 1981, July, 1982, and July, 1983; unsatisfied pent-up demand for big-ticket items, particularly houses and automobiles; declining rates of inflation; falling nominal interest rates; rising household net worth; a generally confident consumer; and an easy availability of finance all have provided the underpinnings for the consumer-spending boom.

During the first three quarters of 1985, the consumer carried the economy upward, with real outlays rising at a 5-percent annual rate, compared with 2 percent for the overall economy. Can the consumer keep it up? Likely not, with the odds favoring a substantial slowdown, but no collapse, in consumer spending during the fourth quarter of 1985 and in 1986.

Current prospects suggest a negative turn in consumer spending during the fourth quarter, a drop of 1 to 1½ percent, as households retrench from the spending and borrowing boom of earlier months. In particular, expenditures on durable goods are expected to decline nearly 20 percent, at an annual rate, reflecting a huge decline in automobile sales—from 12.4 million units in the third quarter to 9.2 million units in the fourth quarter. Other categories of consumer outlays should rise only slowly, as households attempt to save more out of modest increases in income.

For 1986, the range of growth expected for consumption spending is 2 to 2½ percent, with considerable weakness in



Allen Sinai

The consumer: Slowing but no collapse.

spending for durables and nondurables, but less of a slowing for services. Sluggish growth in real disposable income, a need to work debt-to-income ratios lower, still high debt service, and caution in buying as saving is increased are major reasons for the reduced pace of spending.

Automobile sales will be one of the casualties of the retrenchment, averaging 10.5 million units in 1986 compared with 10.8 million in 1985. Nearly 30 percent of auto sales can be expected to be in imports. Retail sales are also likely to grow more slowly, rising 6.3 percent in nominal terms. Households will remain cost and bargain conscious, given that past spending and borrowing behavior has resulted in an overextended financial position. A weaker consumer picture can be expected for the following reasons:

- Households must begin to retrench at this point because the heavy spending of previous quarters has outstripped growth in real disposable income, has brought sharply higher indebtedness relative to income, is engendering high and rising debt service, and has resulted in an extraordinarily low rate of personal savings. Clearly, consumers cannot keep up the previous pace of spending and borrowing. The issues are when and how much of a decline is in prospect.

- The financial position of households has deteriorated considerably. Debt ratios—for consumer or mortgage credit, or both—are at a post-World War II high as a percent of disposable income—78 percent for total debt/income during the third quarter. Delinquency rates on both installment credit and mortgages are also at or near postwar highs. Debt service—the interest charges on auto loans and on mortgages—too is at a new high at 11.1 percent of income, according to a proxy measure estimated by Shearson Lehman Brothers.

- Real disposable income is no longer growing rapidly. Over the next year, only a 2.4 percent rise can be expected. No further stimulus from tax reductions is in prospect.

- Household net worth, defined as the difference between household financial and physical assets and household liabilities, expressed in real terms, will be growing more slowly than previously.

CONSUMER FORECASTS

	Actual 1984	Est. 1985	Projected 1986
Real Consumption			
(% change)	5.3	3.9	2.1
Durables (% change)	13.1	7.5	0.0
Nondurables (% change)	4.6	2.4	1.7
Services (% change)	3.2	4.0	3.3
Auto sales (mill. units)	10.4	10.8	10.5
Retail sales (current \$)	10.5	6.3	3.8
Real disposable income			
(% change)	6.7	2.2	2.4
Consumer price index			
(% change)	4.3	3.4	3.4
Mortgage and auto			
repayments as percent			
of income	45.9	44.2	43.5

- Consumer sentiment, as measured by the University of Michigan Survey index, is expected to moderate in the months ahead.

Why No Downturn?

No collapse or sustained decline in household spending should be expected, however, so long as inflation rates remain relatively low. Employment growth has been substantial, with three million new jobs created over the past year. Most of these have been in services where incomes are lower, but nevertheless jobs seem secure. In general, households seem reasonably optimistic about the future and plan to sustain spending. Other reasons include the stability expected for interest rates and the fact that the consumer balance sheet, while worsening con-

siderably, has not deteriorated enough to cause an outright decline in spending.

Several major risks are present in the economy. One is the personal savings rate, which remains a puzzle. A sudden increase in the personal savings rate to 4 or 5 percent would mean a precipitous drop in consumer spending and, probably, a recession. Other major uncertainties for consumer spending lie in the possibility of tax reform and in negotiations over the budget in Washington. Tax reform, with its reductions in tax rates for consumers, would likely stimulate consumer spending more than is currently expected for 1986. Another tightening of the budget, if accompanied by monetary easing, would be likely to lower interest rates and raise equity prices, which should bring a strong response in consumer spending, especially in the interest-rate sensitive areas.

The Outlook for Capital Spending

Adrian T. Dillon

The growth of capital spending in the current economic expansion to date has been "out of bounds" compared with previous historical experience. Based on the Commerce Department's preliminary third-quarter numbers, fixed investment has risen over 35 percent since the economic trough in late 1982. This is almost double the 19-percent average increase experienced to this point in previous post-World War II expansions, and 10 points faster than the previously most rapid experience.

More recently, however, the pace of this capital spending "boom" has slowed sharply: Investment has risen at less than a 2½-percent annual rate since last year's fourth quarter and, in fact, spending has dropped in two of the past three quarters. After its extraordinary performance earlier in the cycle, is capital spending now "regressing toward the mean" of past historical performance, suggesting substantial weakness ahead? I think not. Most of the volatility in capital spending this year has been due to the weakness in office and computing machinery, which now represents 26 percent of total capital equipment spending. Excluding computers, total spending for producers durable equipment this year has risen at a very steady 4.8-percent annual rate.

Looking ahead, capital spending should support but not lead overall economic growth, rising 3½ to 4 percent during 1986. Perhaps more important, various categories of capital spending will perform far differently from the overall average. Capital equipment spending should rise 4 to 5 percent driven by an 8 to 10 percent rebound in "high tech" spending: Computer purchases should be up 10 to 15 percent, while spending on communications equipment should rise about 10 percent. Other categories of equipment spending should

Adrian T. Dillon

No relief from pervasive global competition.



fare less well, however. Purchases of mobile equipment, after a 5 to 6 percent increase this year, should be down somewhat during 1986, due to modestly lower auto and truck purchases and to a sharp decline in commercial aircraft shipments. Purchases of stationary equipment (machine tools, special and general industry equipment, and transmission and distribution equipment) will follow the path of stagnant manufacturers' capacity utilization, rising about 2 percent next year after a 3 percent rise in 1985.

Categories of nonresidential construction (nearly one-third of total capital spending) will show similarly divergent trends. Commercial and industrial construction has been booming, with a 19-percent increase in value put in place this year, following 1984's 28-percent rise. However, office vacancy rates now average about 16 percent nationwide and new office construction contracts are beginning to weaken; office construction will be flat at best next year, and sharply lower in 1987. Store construction, on the other hand, should continue to show

good gains, following the trends of housing starts and completions. Finally, industrial construction, which has been very flat recently, should continue that pattern into 1986. Overall, after a 15.5-percent gain last year and a 10 percent expected rise in 1985, total nonresidential construction should be up 2 to 3 percent during 1986.

Answering the Pessimists

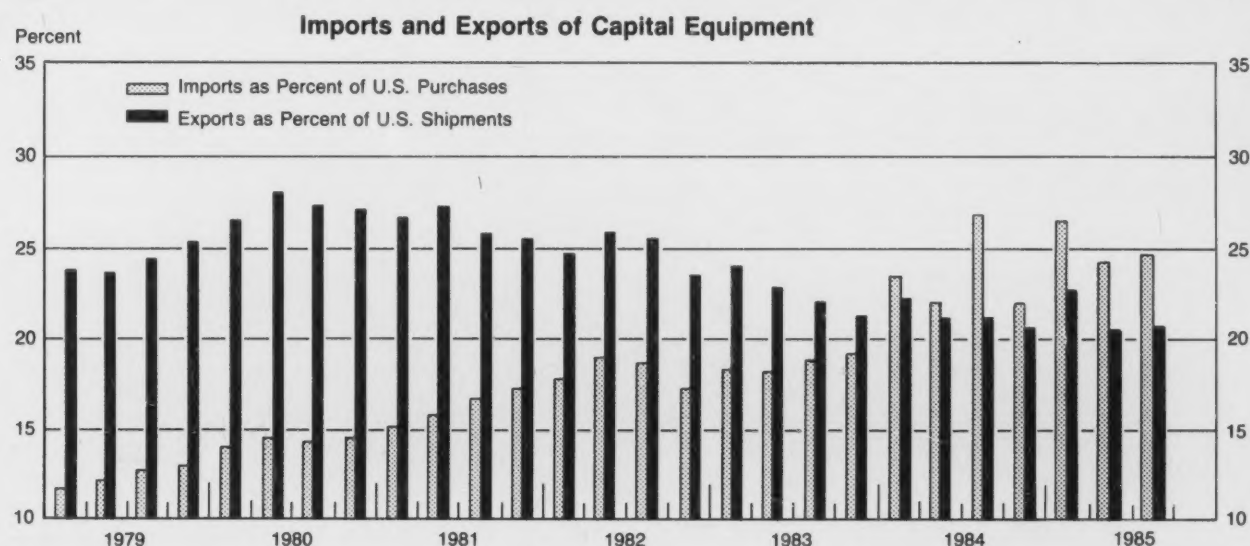
Looking at the determinants of capital spending, pessimists about the investment outlook generally point to two factors that could depress spending over the next year, even assuming that the general expansion continues: First, that current capacity in place is more than sufficient to handle a modest pickup in growth; and, second, that spending will be constrained by the year-long trend of declining after-tax corporate profits. Both arguments contain elements of truth, but should be considered in a broader context.

First, it is true that manufacturers' operating rates have been declining over the past year, tracking closely the trend of declining manufacturing employment. It is important to remember, however, that we are having a sharply bifurcated expansion, with a 1-percent annual decline in manufacturing employment over the past year more than offset by a 4-percent average growth in services employment. Manufacturing today represents only 19 percent of total employment and about 25 percent of total output. And, while demand for capital goods by manufacturers may be flat over the next year, that represents less than one-third of typical capital goods demand. It seems reasonable to assume that the trend of capacity utilization in services more closely tracks the very steady 4-percent growth

of employment, and that sustained demand from that 70 percent of the economy should support modestly higher overall capital spending.

Looking at the impact of profits on capital investment, it is important to remember that reported after-tax profits may vary dramatically from economic profits and from operating cash flow. Historically, there has been a poor correlation between after-tax profits and fixed investment; capital spending has been much more closely related to total cash flow, which includes depreciation expenses, inventory-valuation adjustments, and, in recent years, the very substantial positive difference between book and economic depreciation. With profits also expected to be modestly higher next year, there should be no financial constraints on a modest rise in investment spending.

Three to five percent growth next year may be too optimistic a forecast, however, for real U.S. *shipments* of capital goods, because there will be no relief from increasingly pervasive global competition. Since 1980, imports have risen from about 14 percent of U.S. purchases of capital goods to about 25 percent; over the same time period exports as a percent of U.S. shipments have fallen from 27 percent to below 21 percent (see chart). Consequently, while the "boom" in U.S. capital goods *purchases* has brought spending to a level 24 percent above its previous cyclical peak, U.S. *shipments* of capital goods remain no higher than five years earlier. Unless the U.S. dollar falls sharply further in the months ahead or the growth of foreign economies picks up sharply, U.S. manufacturers of capital goods will find it very difficult to achieve 3 to 5 percent growth in the year ahead.



Housing and Housing Finance

Lyle E. Gramley

The easing of monetary policy that got under way in the Fall of 1984 has had less effect on housing activity than many forecasters had anticipated. Mortgage interest rates have fallen about two percentage points from their peaks in 1984, and might have been expected to push housing starts into the 1.8 to 2.0 million unit range at annual rates. Starts *have* increased significantly from their trough in October, 1984, but they reached a peak of around 1¾ million units at an annual rate in early 1985, and have actually come down somewhat since then. Residential building permits, however, have remained on a plateau, and sales of new homes have risen somewhat further.

This rather limited response of housing to declining mortgage interest rates may partly reflect continued relatively high real interest rates, home buyers' reluctance to take on the interest-rate risk associated with ARM's, and the reduced attractiveness of houses as an investment in an environment of relatively stable house prices. The largest factor, however, appears to be the tightening of underwriting standards in the residential-mortgage-credit field that got under way, coincidentally, at about the time that mortgage interest rates began to fall. Potential home buyers found mortgage credit available at lower cost, but fewer of them were able to qualify for loans.

Private mortgage insurers, facing rising foreclosures and larger payouts on mortgages covered by their guarantees, began to insist on higher quality mortgages in the portfolios that they accepted for insurance. Even more importantly, mortgage banking companies—whose principal source of income is from servicing mortgage portfolios—were experiencing markedly increased servicing costs because of rising delinquencies, and responded by adopting stricter underwriting standards, particularly lower loan-to-value ratios.

These developments began in the conventional mortgage market, but gradually spread to the market for government-

Lyle E. Gramley

Tightening of mortgage standards will limit homebuilding.



guaranteed mortgages as well. Further impetus to the tightening of standards occurred in August, 1985, when FNMA announced a general tightening of standards on the mortgages it would purchase.

At today's mortgage interest rates, there is little basis for anticipating a marked improvement in housing production. In coming months, housing starts should rise relative to permits, regaining a more normal relationship between these two series. But the tightening of underwriting standards, which has yet to run its course fully, will limit any substantial further improvement in housing activity.

The financial environment for housing and housing finance is expected to remain relatively favorable in 1986. Interest rates are expected to be stable to declining moderately in the first half of the year, when the economy is expected to grow slowly, but to begin turning up in the second half with a strengthening economy. By the fourth quarter of 1986, however, mortgage interest rates are expected to be only marginally above the levels of a year earlier. In such an environment, housing starts in 1986 should remain fairly close to 1985 levels, acting as a supporting factor for the overall economy, but not as a significant source of stimulus.

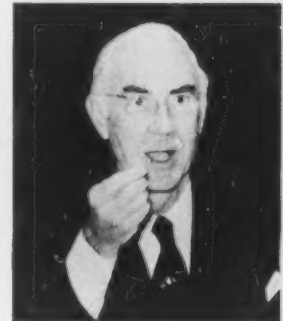
Capital Markets in Uncharted Waters

Daniel S. Ahearn

The psychology of the U.S. credit and capital markets has recently improved, and stock and bond prices have risen correspondingly. The better tone reflects a widespread belief that further easing of Federal Reserve monetary policy is imminent, and an expectation that coordinated intervention in the foreign-exchange market can lower the value of the dollar without causing any damaging side effects such as a diminution of foreign-investors' interest in U.S. securities. Psychology can dominate any market for a time, but whether this optimistic mood will last beyond the short term depends on whether these expectations are borne out.

Further, the current low level of inflation is comforting to the markets which, for the time being, are paying little attention to the build-up in traditional precursors of future inflation: high monetary growth, large budget deficits, a sinking foreign-exchange value of the currency. The equity market has benefited from a supply-demand improvement caused by the massive substitution of debt for equity in financing mergers and buyouts, and appears unconcerned by the greater vulnerability to economic adversity that the increased leverage implies. Meanwhile, in a broader context, the internationalization of the U.S. capital market, the enormous number of new capital market instruments not yet tested by adversity, and the unprecedented scale of demands on the market have introduced new complexities into any appraisal of the outlook. In summary, the credit and capital markets appear reasonably satisfied and hopeful about current developments and unconcerned about less constructive implications that lie just below the surface or just over the horizon.

The reality is that the U.S. capital market is in uncharted waters. No country on earth has ever run budget deficits on a \$200-billion-a-year scale. No country before has ever had a \$140-billion trade deficit. At the same time, traditional relationships no longer seem to apply. In the past, countries with budget and trade deficits typically saw their currencies weaken substantially. Yet the foreign-exchange value of the dollar doubled over the past four years, a time when our budget and trade deficits were mushrooming. The rate of inflation has not risen cyclically in this expansion as it usually does, in good part because the strong dollar led to a flood of low-priced foreign imports. Interest rates, which usually rise late in the cycle, are lower today than they were in the recession trough. This reflects continuing low inflation and, more importantly, the fact that the Federal Reserve has kept money easy to prevent the adverse impact of the strong dollar on the U.S. industrial sector from causing a business recession and precipitating a crisis among weak domestic and international debtors. The Fed's easy-money policy, in turn, has accommodated a plethora of mergers and leveraged buyouts whose common denominator has been enormous recourse to debt, thus producing still more vulnerable debt structures.



Daniel S. Ahearn

Sunny, but storm clouds developing.

In the face of all this, the U.S. credit and capital markets have functioned impressively. The S&P 500-stock average is up about 80 percent from its 1982 low, well in excess of most post-World War II bull-market gains. Bond yields have dropped nearly 400 basis points from their 1984 yield peaks, the biggest nonrecession yield decline in history. With all this behind them, the markets appear extended and could be volatile in responding to changes in fundamentals.

The most important fundamental is probably the outlook for the economy. If evidences of a near-term recession should develop, as many expect, the stock market would probably drop sharply, commodity prices and bond yields would come under new downward pressure, and a new bull market in bonds would get under way with a subsequent beneficial effect on stock markets. However, a persuasive case can be made for the U.S. economic expansion continuing well into—if not throughout—1986. Such further economic expansion presumably would mean continuing strong credit demands on the credit and capital markets.

Whether such credit demands could continue to be accommodated without raising interest rates probably depends most importantly on the behavior of foreign investors. It was foreign investors' eager appetite for U.S. securities over the past three years that supplemented U.S. domestic savings and prevented record budget deficits and record private credit demands from raising U.S. interest rates. It was also foreign investors' strong demand for U.S. securities that kept the dollar high despite an unprecedented U.S. trade deficit. And it was large volumes of low-priced imports encouraged by the high dollar that took away price-raising ability from U.S. business and kept U.S. inflation at recession levels, despite an easy Federal Reserve monetary policy and an unprecedented budget deficit.

Thus, whether foreigners will continue to be aggressive buyers of U.S. securities is an important and still unanswered question. In the past three years, foreigners have had not only large appreciation on their portfolios of U.S. securities, but also very sizable gains because of the rise of the dollar. How

will they react to the exchange losses that are following the recent decision of the United States and the four major industrial nations to reduce the foreign-exchange value of the dollar? Japanese investors, who were buying U.S. bonds for a four or five percentage point income advantage, suffered a fifteen point exchange loss in the first three weeks after the meeting, wiping out three to four years of extra income. European investors still remember much larger dollar-exchange losses in the late 1970's, losses that in many cases exceeded their returns from U.S. securities. If foreign investors become less eager buyers of U.S. securities, this alone would be an important force for higher U.S. interest rates in the years ahead, since foreigners have been supplying about \$130 billion a year to the U.S. capital market—equal to about two-thirds of the U.S. budget deficit or about one-fifth of total annual U.S. gross yearly investment in plant, equipment and inventories.

More Volatility

It is potentially significant that the character of overall demand for credit appears to be changing in ways that suggest greater interest-rate volatility. In the past, when interest rates rose sharply, many prospective borrowers postponed their issues, reducing their demand for credit and limiting the rise in rates. In economists' terms, the demand for credit was elastic with respect to interest rates. But now there are reasons to believe credit demand has become more inelastic.

The Federal Government, which has always been an inelastic borrower (it pays whatever interest rate is needed to fill its needs), now accounts for a greater share of total borrowing, thus increasing average interest-rate inelasticity. More important, the corporate sector has become increasingly inelastic in its demand for funds. The major reason is the much more leveraged position of the business balance sheet, a high propor-

tion of which is short-term debt, and the lower percentage of cash to liabilities. Thus, many companies no longer have the luxury of postponing debt issues if rates seem high. Short maturities must be refinanced, regardless of the interest-rate level, if bankruptcy is to be avoided. Moreover, the increasing number of weak credits in a variety of industries and sectors mean more necessitous borrowers who have to have money regardless of rate. With credit demand more inelastic with respect to interest rates, rates will rise more for any given rise in credit demand.

The U.S. capital market outlook is also complicated by important legislative uncertainties. It is still unclear whether, when and in what form the President's tax-reform proposal will be enacted, but the economy and the markets could be affected substantially. The budget-deficit problem has stimulated the Gramm-Rudman-Hollings amendment aimed at eliminating the deficit over a six-year period. The amendment will probably be enacted to avoid a debt crisis, but it has not had adequate review: Its consequences are not at all clear, and even its constitutionality is suspect.

Summing all this up, it seems likely that recent bond-market optimism will be severely tested before long if business activity holds up, the Fed does not cut the discount rate, and the dollar declines further. Equities should benefit so long as bond-market optimism is high, and should be supported for a while when interest rates begin to rise again by the outlook for better earnings as a result of a lower dollar and the encouragement of better-than-expected business activity over the next few quarters. However, legislative uncertainties are unlikely to be resolved and, hence, will continue to be a force for volatility in the credit and capital market. Thus, it is possible to see some developing storm clouds beyond a reasonably sunny near term.

Equity Market Outlook

Robert G. Wade, Jr.

The outlook for the economy is positive, in our view. We expect GNP growth to pick up to *at least* trend-line levels (3 percent or so) during 1986 and, hopefully, beyond. Within this environment, we expect inflation to remain calm and the exchange value of the dollar to move irregularly lower.

Federal Reserve policy has now been accommodative for over a year and continues to be benign, and these efforts should result in continued economic growth. We feel the chances of a recession are low in the absence of a restrictive monetary policy. With inflation pressures subdued and continued concerns about economic growth being expressed, any changes in current Fed policy may be on the side of ease.

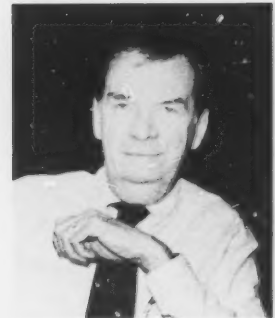
The prospects we see for the equity market are, of course, closely related to our outlook for the economy. As is well known, the equity market typically turns south in advance of an oncoming recession, generally with a lead time of three to nine months. However, since we do not see the seeds of recession being planted as yet, the cyclical support for equities remains in place.

We find that equity-market returns are more closely related to Federal Reserve policy (and the associated interest-rate and liquidity structure) than to any other single factor. As noted above, these factors are positive, as they have been for the past year or so.

In addition to monitoring the cyclical environment, we also pay considerable attention to what other investors are saying and doing, with an eye to being contrary. On this score, our equity-market outlook has improved in recent weeks, primarily because our data reflect an increase in investor worries and pessimism. Consequently, the concerns that exist today—in contrast to a more ebullient outlook that was prevalent in the Spring—are lending support to our relatively sanguine outlook for the equity market.

Many have noted that the supply of equities has shrunk to an unprecedented degree over the past two years, due to mergers, leveraged buy-outs, share-repurchase programs, and so forth. This reduction of supply should, of course, have favorable implications for the equity market. In addition, if one considers that institutions are holding their highest cash reserves since year-end 1984 (reflecting the aforementioned concerns about the market), and that individuals are becoming increasingly less satisfied with their reduced returns on fixed-income instruments (particularly shorter-term securities), a bullish supply-and-demand case can be built for equities.

If we considered the stock market to be cheap, a very bullish case for equities could be made, in our opinion. Unfortunately, on an absolute basis, we think that the equity market is fairly valued, at best. This situation reflects primarily the fact that stock prices (S&P 500) are up about 90 percent since July, 1982. (Over



Robert G. Wade, Jr.

The equity market is fairly valued.

the long run, stock-market prices grow in line with the nominal economy. Clearly, then, the rates of gain experienced in recent years are unsustainable.) Another factor with an impact on our valuation case is the fact that, while stock prices have soared, the supporting growth of dividends and earnings has been below average.

In addition to no longer being cheap on an absolute basis, the demand for stocks continues to be affected by relatively attractive bond yields. For example, we currently expect equities to provide approximately a 12-percent return over the long run. This compares with bond yields that are only 1 to 2 percent lower. Consequently, many investors, particularly pension funds, are not excited about increasing their equity exposures relative to the risk involved.

Our outlook on fixed-income investments is not as favorable as our opinion about the prospects for the equity market. To be sure, the lack of economic pressures (e.g., still slightly falling capacity utilization), the lack of financial pressures (e.g., a positive slope of the yield curve), and an absence of inflation pressures (e.g., a flat producer price index this year), all auger well for the bond market. In addition, the still relatively high level of real interest rates should continue to attract capital to the fixed-income markets. However, continued economic growth should, at some point, increase credit demands and possible concerns about inflation. Hence, we would not be surprised if the fixed-income markets came under pressure at some point over the next year or so. In the meantime, with current negative pressures relatively absent, the bond market could perform reasonably well.

All in all, we are recommending that equity exposure levels be above average and about midway between a "normal" exposure and a fully aggressive commitment. We are approximately neutral on bonds. Continued economic growth will be the key ingredient for equities to outperform fixed-income investments.

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**Research
Bulletin**

No. 191

The Conference Board

**Top Executive Compensation
in U.S.-Based Multinationals**

1986 Edition

*by Harland Fox and
Charles A. Peck*

Management Summary

- For the second consecutive year, this survey of top executive compensation practices in U.S.-based multinational manufacturing companies did not reveal marked differences from the practices of the larger spectrum of U.S. manufacturing companies.
- For these multinationals, 1984 total compensation was 11 percent greater than in 1983. Bonuses paid for 1984 were 14 percent greater than 1983 awards, and 1984 base salary was up nine percent over 1983.
- Stock option plans were reported by 93 percent of the surveyed companies. Half reported long-term performance share or unit plans. One-quarter had plans for awarding shares of restricted stock.

Human Resources Program

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Top Executive Compensation In U.S.-Based Multinationals

1986 Edition

For the second consecutive year, The Conference Board has examined the compensation paid top executives in a sample of internationally involved United States manufacturing companies. This is in response to the continuing interest in the compensation practices of U.S.-based multinational companies as compared with the practices of those companies operating only within the domestic United States.

This bulletin looks at the compensation of the five highest paid executives in 122 multinational companies. For ease of comparison, the information is presented in the same general format as The Conference Board's annual study of top executive compensation.¹ This larger study is based on a sample of 475 U.S. manufacturing companies.

It is hoped the information provided here will prove helpful to executives involved with multinational operations. Probably the most general conclusion to be drawn from the data is that compensation practices in U.S.-based multinationals do not differ markedly from those of the larger spectrum of U.S. manufacturing companies.

The Multinational Companies

A multinational company, for the purpose of this study, is any manufacturing company that meets any two of the following criteria:

- (1) Thirty percent or more of total sales are outside the United States.
- (2) Foreign sales are at least \$250 million.
- (3) Manufacturing operations controlled by the U.S. parent are located in at least five countries.

Based on an analysis of the overseas operations of some 2,000 manufacturers, 189 met at least two of the criteria.

Data on the 1984 compensation of their five highest paid executives were obtained for 122 of these manufacturers, from a study of 475 manufacturers with sales of \$100 million or more whose stock is listed on the New York or American Exchange.

¹ See Harland Fox and Charles A. Peck, *Top Executive Compensation 1986 Edition*, The Conference Board, Report No. 875, 1985.

These multinational companies are classified in the tabulation below according to their 1984 sales volume.

1984 Sales	Companies	
	Number	Percent
\$10 billion or over	20	16%
5—9,999 billion	17	14
4—4,999 billion	12	10
3—3,999 billion	15	12
2—2,999 billion	13	11
1—1,999 billion	23	19
500—999 million	15	12
100—499 million	7	6
Total	122	100%

Median sales for the group are \$3.2 billion, with the middle half ranging between \$1.4 billion and \$6.1 billion.

Pay Trends

Total compensation for 1984 (which includes bonus awards) was 11 percent greater than in 1983 as illustrated by the median change for the chief executive officer position in companies for which both 1984 and 1983 total compensation data were available. In these 105 companies, the median change in total compensation for the chief executive officer position was 11 percent, with the middle half ranging from an increase of five percent to 21 percent.

For 17 percent of these chief executive officer positions, total compensation for 1984 was lower than for 1983, and two percent (two cases) registered no gain. Among the 81 percent that show an increase, the median increase is 14 percent, with the middle half ranging between eight and 28 percent.

Some of the increase in total compensation is the result of increased bonus payments. Among the 87 companies that paid a bonus to the chief executive position in both 1984 and 1983, the median increase was 14 percent, with the middle half ranging from an increase of three percent to 35 percent. Among the 78 percent that got a larger bonus, the median increase

was 20 percent, with the middle half ranging from 10 to 44 percent.

Total compensation also increased because of increases in base salary. Among the 104 companies for which both 1984 and 1983 base salary were available, the median increase for the chief executive position was nine percent, with the middle half ranging between a five percent and a 12 percent increase. For eight percent of these chief executive positions, salary was lower in 1984 than in 1983, and for 10 percent it was unchanged. Among the 82 percent that received an increase, the median is 10 percent, with the middle half between seven and 13 percent.

Total Compensation

For each multinational manufacturer, compensation data were obtained for the five highest paid executives without regard to title or function. The highest paid executive is almost always the chief executive officer, and the second highest paid, the chief operating officer.

The 1984 *total compensation* of each of the five highest paid executives in each company is measured as the sum of the 1984 salary and 1984 bonus award. The median and middle 50-percent range of the total compensation of the chief executive officers and the other four executives are shown below.

Compensation Rank	1984 Total Compensation	
	Median	Middle 50 Percent Range
Highest Paid	\$723,000	\$525,000 to \$925,000
Second	462,000	320,000 to 622,000
Third	380,000	263,000 to 485,000
Fourth	309,000	243,000 to 427,000
Fifth	293,000	220,000 to 383,000

As the regression lines of Chart 1 illustrate, there is a positive relationship between the level of total compensation and sales volume for all five executives. The correlation coefficients for the five lines are, respectively: 0.84; 0.81; 0.83; 0.83; and 0.84.

The regression lines on the chart can be used to determine the average compensation of an executive at any level of company sales, either by a direct reading from the chart or by using the regression formulas below. (In these formulas, Y is total compensation stated in *thousands* of dollars; that is, \$532,000 is 532. X is sales volume stated in *millions* of dollars; that is, \$248,000,000 is 248.)

Rank	Regression Formula	r ²
Highest paid	$\log Y = 1.8807 + 0.2734 \log X$	70%
Second	$\log Y = 1.6523 + 0.2877 \log X$	66
Third	$\log Y = 1.5409 + 0.2922 \log X$	69
Fourth	$\log Y = 1.5118 + 0.2829 \log X$	69
Fifth	$\log Y = 1.4271 + 0.2957 \log X$	71

Although total compensation and sales are highly related, company size is not the sole determinant of total compensation levels. As the "coefficients of determination" (r²) above indicate, the variation in sales volume statistically explains only 66 to 71 percent of the variation in total compensation of the five top-paid executives.

The ratio of the total compensation of each executive to that of the chief executive officer is shown below.

Compensation Rank	Total Compensation as a Percentage of CEO's Total Compensation	
	Median	Middle 50 Percent Range
Second highest	69%	61% to 76%
Third highest	53	47 to 60
Fourth highest	45	41 to 53
Fifth highest	42	37 to 47

Salary

The median and middle 50 percent range of the *base salary* of the five highest paid executives are shown below.

Compensation Rank	1984 Base Salary	
	Median	Middle 50 Percent Range
Highest paid	\$450,000	\$381,000 to \$541,000
Second	314,000	245,000 to 393,000
Third	250,000	202,000 to 305,000
Fourth	213,000	183,000 to 275,000
Fifth	200,000	162,000 to 245,000

Again, there is a strong relationship between the level of base salary and company sales volume, as illustrated on Chart 2. The correlation coefficients for the five lines are, respectively: 0.83; 0.78; 0.81; 0.80; and 0.81. The equations for these lines are shown below.

Rank	Regression Formula	r ²
Highest paid	$\log Y = 1.9568 + 0.1985 \log X$	69%
Second	$\log Y = 1.7617 + 0.2072 \log X$	61
Third	$\log Y = 1.6489 + 0.2133 \log X$	65
Fourth	$\log Y = 1.5836 + 0.2150 \log X$	64
Fifth	$\log Y = 1.5462 + 0.2157 \log X$	66

As the "coefficients of determination" (r²) indicate, the variation in sales volume statistically explains 61 to 69 percent of the variation in base salary of the five top-paid executives. These coefficients are essentially similar to the coefficients for total compensation shown earlier.

Chart 1: Total Compensation: Five Highest Paid Executives

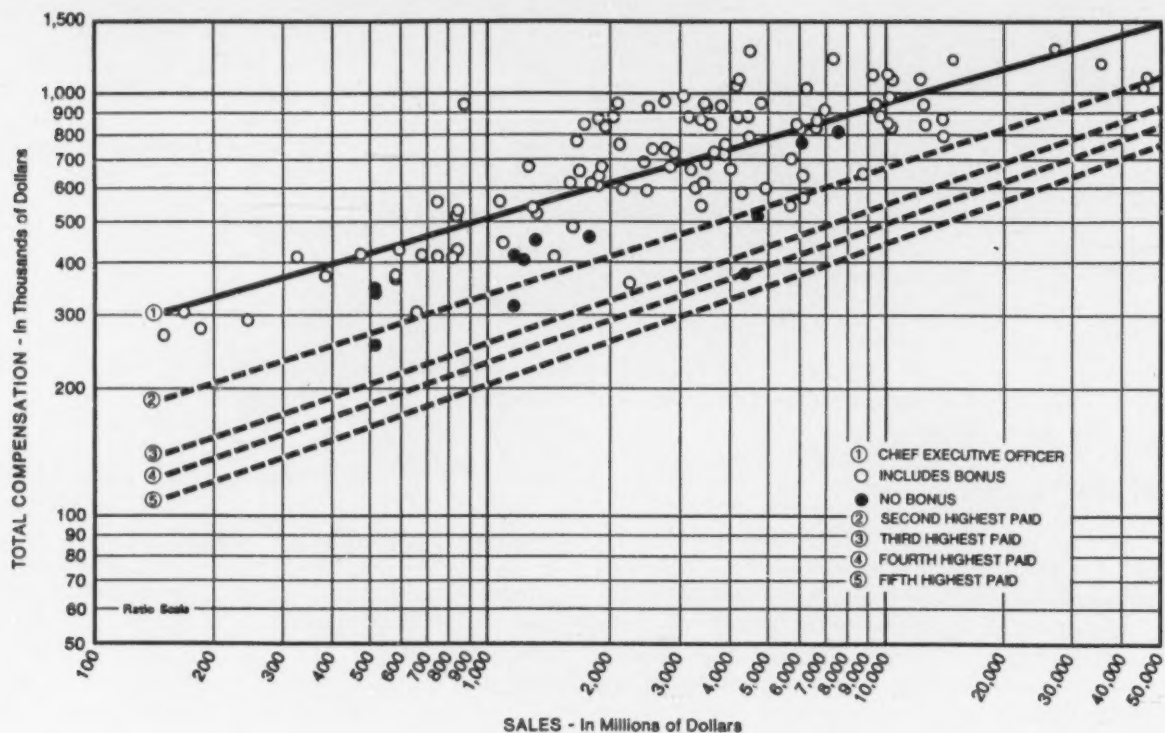
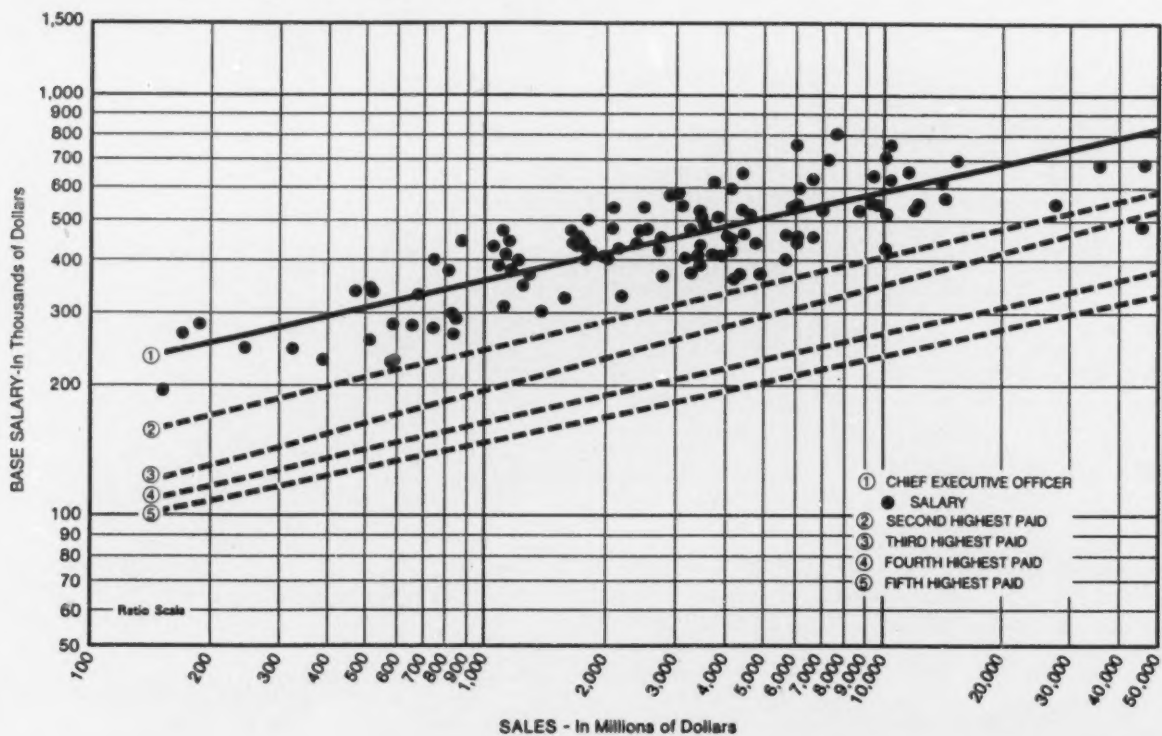


Chart 2: Base Salary: Five Highest Paid Executives



The ratio of the base salary of each executive to that of the chief executive officer is shown below.

Compensation Rank	Base Salary as a Percentage of CEO's Salary	
	Median	Middle 50 Percent Range
Second highest	71%	61% to 77%
Third highest	54	49 to 63
Fourth highest	48	43 to 54
Fifth highest	44	39 to 50

These base-salary ratios are essentially the same as the total compensation ratios.

Annual Bonus Awards

All but six of the 122 multinational manufacturers have an "annual" bonus plan; that is, a plan that pays a year-end bonus that is based on that year's corporate financial performance. In general, the bonus award tends to increase as a percentage of salary as base salary increases. This explains, in part, why the median award for the chief executive officers, 62 percent of salary, is larger than that for the second highest paid, 57 percent; the third highest paid, 53 percent; the fourth highest paid, 50 percent; and the fifth highest paid, 47 percent of base salary. (See Table 1.) Similarly, bonus awards for each of the five executives tend to increase as the size of the company increases, as does base salary. (See Table 2.) Data from the table are derived from the regression equations below which are based on the pay of executives in 106 compa-

nies that paid a bonus. (The coefficients of determination are in parentheses.)

	Total Compensation	
		r ²
Highest paid	$\log Y = 1.9416 + 0.2605 \log X$	(72%)
Second	$\log Y = 1.6997 + 0.2784 \log X$	(67)
Third	$\log Y = 1.5966 + 0.2810 \log X$	(71)
Fourth	$\log Y = 1.5753 + 0.2690 \log X$	(71)
Fifth	$\log Y = 1.4744 + 0.2858 \log X$	(72)
	Base Salary	
Highest paid	$\log Y = 1.9639 + 0.1952 \log X$	(70%)
Second	$\log Y = 1.7625 + 0.2058 \log X$	(61)
Third	$\log Y = 1.6676 + 0.2077 \log X$	(65)
Fourth	$\log Y = 1.6026 + 0.2089 \log X$	(64)
Fifth	$\log Y = 1.5543 + 0.2122 \log X$	(67)

Long-term Performance Share/Unit Plans

In recent years, some companies have adopted incentive plans for executives in which the reward is based on the attainment of specified *long-term* corporate financial performance goals, in contradistinction to the annual bonus plans that are based on a single year's corporate performance.

Under these plans, top executives are given a contingent award of company shares or, more commonly, performance units at the beginning of a performance period of three, four or five years. The actual value of the award is determined by how closely specified corporate financial performance objectives (usually growth in earnings per share) are met over the course of the performance period. As a rule, a new perfor-

Table 1: 1984 Annual Bonus Awards, and 1983 Median Bonus

1984 Bonus Awards (Percent of Salary)	Chief Executives		Second Highest Paid		Third Highest Paid		Fourth Highest Paid		Fifth Highest Paid	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
100% or more	13	12%	10	9%	8	7%	8	7%	10	9%
90-99	4	4	2	2	2	2	2	2	2	2
80-89	9	9	5	5	5	5	4	4	3	3
70-79	17	16	16	15	12	11	7	6	10	9
60-69	16	15	12	11	14	13	15	14	11	10
50-59	14	13	21	19	18	17	20	18	14	13
40-49	12	11	17	16	18	17	20	18	22	20
30-39	8	7	11	10	15	14	17	16	13	12
20-29	9	8	7	7	9	8	10	9	14	13
Less than 20%	7	6	7	7	8	7	6	6	10	9
Total	109	100%	108	100%	109	100%	109	100%	109	100%
Median Bonus	62%		57%		53%		50%		47%	
Middle 50% Range	43-78%		41-72%		39-70%		36-65%		32-69%	
1983 Median Bonus	58%		55%		50%		50%		44%	

Table 2: Bonus Awards (as Percent of Salary) by Company Size

Executive	Sales Volume		
	\$1.4 billion	\$3.2 billion	\$6.1 billion
Chief Executive Officer			
Bonus (% Salary)	53%	61%	68%
Salary	\$378,000	\$445,000	\$504,000
Second Highest Paid			
Bonus (% Salary)	46%	55%	63%
Salary	\$257,000	\$305,000	\$348,000
Third Highest Paid			
Bonus (% Salary)	45%	53%	61%
Salary	\$209,000	\$249,000	\$284,000
Fourth Highest Paid			
Bonus (% Salary)	45%	53%	59%
Salary	\$182,000	\$216,000	\$247,000
Fifth Highest Paid			
Bonus (% Salary)	41%	50%	58%
Salary	\$167,000	\$199,000	\$228,000

mance period is created each year or, in some cases, every two years; that is, performance periods overlap.²

About half (62) of the multinationals have a long-term performance share/unit plan. The plans are more common among the larger companies; for example, 65 percent of the 37 companies with sales of \$5 billion or more have a plan compared with 63 percent of the 27 companies with sales of \$3 to \$5 billion, and 36 percent of the 58 companies with sales under \$3 billion.

Twenty-six companies made a payment during 1984 to one or more of their five top-paid executives under these plans. Payments to 118 executives are shown below, converted to a percentage of their 1984 base salary.

Payment as Percent of Salary	Executive	
	Number	Percent
100% and over	27	23%
50—99	16	14
40—49	7	6
30—39	20	17
20—29	24	20
Less than 20%	24	20
Total	118	100%

² For an analysis of the characteristics of 89 of these plans, see Harland Fox, *Executive Incentives: Long-Term Performance Share/Unit Plans*. The Conference Board, Research Bulletin No. 132, 1983.

The median payment is the equivalent of 34 percent of 1984 salary, with the middle half of payments ranging between 21 and 94 percent of base salary.

Stock Option Plans

As a general rule, the long-term corporate goals on which performance share/unit plans are based are not stated in terms of an increase in the market price of company stock. Many are an attempt to get away from the vagaries of the stock market; either they are a substitute for a stock option or a complement to it.

By far the most common executive incentive plan, in which the reward is based on the long-term performance of the corporation, is the stock option plan that measures corporate performance solely by the market value of company stock. That is, an executive is given an option to purchase a specified number of shares of stock at a specified price (usually the market price on the date of the grant); the executive may exercise this option to buy during a specified period of time, usually over the ten years following the date of grant.

There are two types of corporate stock options as defined by current tax laws: the "nonqualified" option and the "incentive stock option" (ISO).³ The major differences between an ISO and a nonqualified option are:

- Under an ISO, the executive is not taxed at the time the

³ For an analysis of the characteristics of 189 plans, see Harland Fox, *Incentive Stock Option Plans*. The Conference Board, Research Bulletin No. 148, 1983.

option is exercised if the stock is held for a year (and at least two years from the date of grant). When the stock is sold, any gain is taxed at the long term capital gains rate.

- When a nonqualified option is exercised, the executive pays tax (at ordinary income tax rates with a top marginal rate of 50 percent) on the spread between the option price and current market value. Any further gain is taxed as a capital gain when the stock is sold.

- No individual may be granted ISO's amounting to more than \$100,000 in any year. Nonqualified options may be granted in any amounts.

- ISO's must be exercised in the sequence in which they are awarded. For example, if one ISO was granted at \$50 per share and a subsequent ISO at \$40 per share, the second grant could not be exercised before the first one even if the current market value climbed back to \$50 a share. Nonqualified options have no such restriction on the sequence in which they are exercised.

Ninety-three percent (109) of the 122 multinational manufacturers have a stock option plan, and 82 made stock option grants during 1984 to their top executives. A small group of companies granted *only* ISO's (5) or *only* nonqualified options (16); fifty-nine companies granted *both* ISO's and nonqualified options. The remaining two companies did not specify the type(s) of option granted. Among the 59 companies that granted both types of option, 35 used the nonqualified option only to make larger awards to those executives whose ISO grant reached the \$100,000 limit noted above.

All 82 of the multinationals that granted options during 1984 provided information about the value of the option grant for one or more of their five top executives. (The value of the option is the number of shares multiplied by the market price at time of grant.) The size of the option grants for 396 executives is shown below, converted to a percentage of 1984 base salary.

Value at Time of Grant (Percent of Salary)	Executives	
	Number	Percent
400% or more	13	3%
300—399	10	3
250—299	17	4
200—249	20	5
175—199	12	3
150—174	25	6
125—149	36	9
100—124	47	12
75—99	62	16
50—74	94	24
25—49	48	12
Less than 25%	12	3
Total	396	100%

The median value of the option grant for these executives is 90 percent of base salary, with the middle half ranging between

61 and 148 percent. (It should be noted that grants are made each year by most companies.)

The median grant to chief executive officers (101 percent of salary) is higher than that for the second highest paid (94 percent); the third highest paid (91 percent); the fourth highest paid (90 percent); and the fifth highest paid (78 percent).

One or more of the five top-paid executives in 70 companies exercised a stock option during 1984. The net gain realized (current market value minus option price at date of grant) for 191 executives is shown below, converted to a percentage of 1984 base salary.

Gain at Exercise (Percent of Salary)	Executives	
	Number	Percent
400% or more	8	4%
300—399	5	3
200—299	12	6
150—199	7	4
100—149	16	8
75—99	15	8
50—74	19	10
25—49	49	26
15—24	27	14
Less than 15%	33	17
Total	191	100%

The median gain at exercise is the equivalent of 39 percent of base salary, with the middle half ranging between 21 and 95 percent of 1984 salary. In dollar terms, the gain ranged from less than \$10,000 to almost \$3 million. The median gain was \$129,000, with the middle half ranging between \$49,000 and \$353,000.

Restricted Stock Plans

Restricted stock plans have two major characteristics: (1) The award is an outright grant of company shares; recipients do not have to buy the stock; (2) The shares are forfeitable and nontransferable until the executive completes a specified period of continued employment with the company. The restricted stock grant is, simply, a deferred bonus award, the payout of which is contingent upon continued employment; it is a set of "golden handcuffs" designed to retain selected executives.

This required period of continued employment until *all* shares are released to the executive is the "restriction period." It runs from one to ten years after the date of grant but, most commonly, five, three or four years, respectively. Generally, the executive can vote the shares and receive dividends during this restriction period. Dividends are taxed as received, as though they were additional salary. Similarly, when shares are released to the executive, they are taxed at the market value

on the date of release (not date of grant) and taxed as though they were additional salary.⁴

One-quarter (31) of the multinational manufacturers have a restricted stock plan. Twenty-four of them made an award during 1984. The awards for 103 executives are shown below, converted to a percentage of their 1984 base salary. For this purpose, the value of the award is market value at the time of the award.

⁴ Most plans provide for "partial vesting" during the restriction period; that is, some part of the award is made available periodically prior to the end of the restriction period. For an analysis of 91 plans, see Harland Fox, *Restricted Stock for Executives*. The Conference Board, Research Bulletin No. 159, 1984.

Award as Percent of Salary	Executives	
	Number	Percent
200% or more	6	6%
100—199	13	13
40—99	28	27
30—39	6	6
20—29	16	16
Less than 20%	34	33
Total	103	100%

The median award is the equivalent of 34 percent of base salary, with the middle half of the awards ranging between 17 and 80 percent of salary.

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Financing Export Sales

by Francis A. Lees

Management Summary

- Among the financial problems that face exporters is that of controlling various risks: creditworthiness of customers; risks relating to currency and foreign exchange controls; and the economic and political stability of the customers' countries.
- Surveyed companies attempt to control these risks through more careful screening of buyers than is usual in domestic business; utilization of services offered by banks and other institutions that specialize in international trade; currency hedging; automatic adjustments in selling prices to compensate for adverse shifts in exchange rates; and invoicing in U.S. dollars.
- Exporters responding to this survey generally find that the services offered by commercial banks and other export service organizations are satisfactory. However, only a minority use export credit insurance offered by the Export-Import Bank, Foreign Credit Insurance Association and Overseas Private Investment Corporation.
- Most of the surveyed companies had established Domestic International Sales Corporations (DISC's) under the Federal tax legislation that was in effect from 1971 to 1984. The surveyed exporters made heavy use of their DISC's, most of them channeling 75% or more of their exports through these paper subsidiaries. Most sponsors found DISC's helpful in meeting competition but not absolutely necessary to exporting success.
- Most respondents planned to set up Foreign Sales Corporations (FSC's), a new type of subsidiary permitted under the 1984 Federal tax legislation, even though they regard FSC's as less satisfactory exporting vehicles than the old DISC's.

Financial Management Program

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Introduction

For some years now, U.S. trade deficits have been the subject of considerable public and business discussion. At the same time, the pace of the trend toward internationalization of business has increased. With more companies interested in exporting, The Conference Board believed that it would be useful to survey a sample of companies already engaged in export trade in order to find out how they manage export trade and how satisfied they are with some of the alternative arrangements available to them.

While these data were being gathered, Congress repealed the provision of the Revenue Act of 1971 that permitted U.S. firms to set up paper subsidiaries (Domestic International Sales Corporations), popularly known as DISC's. The principal feature of the 1971 legislation was that a large share of income that would normally be subject to the corporate income tax was allowed to be deferred until the DISC's earnings were distributed to the parent company. This tax incentive was largely eliminated as part of the Tax Reform Act of 1984. Instead, Congress authorized companies to set up a new type of entity, a Foreign Sales Corporation (FSC). The same legislation permitted a modified form of DISC. This legislation is of particular concern to financial managers because of the questions of accounting for the previously deferred taxable income. Therefore, a second survey was conducted—

specifically concerned with DISC-and FSC-related tax incentives.

The results of both brief studies are presented here as Parts I and II, respectively, of this paper.

Objectives of This Research Project

This research project was designed to help two groups of readers. One is composed of business people who are familiar with exporting in a general way but who wish to be brought up to date on current practices. The others are those who are just beginning to be involved with exporting and who need an introduction to the customs, services and incentives presently existing.

The research was limited to practical, day-to-day considerations in the financial management of the export function. Other aspects of exporting have been covered in the following Conference Board publications:

John Hein, *The Dollar and U.S. Exports: Some Q and A's*, The Conference Board, Research Bulletin No. 158, 1984.

Virginia Yorio, *Adapting Products for Export*, The Conference Board, Report No. 835, 1983.

Shirley Rhine, *The Impact of Regulations on U.S. Exports*, The Conference Board, Report No. 809, 1981.

Part I: Financial Management of Export Sales

The major purpose of the first survey was to examine the basic financial tasks that must be discharged in exporting, and to describe which are accomplished in-house and which are provided by others. (The companies responding are described in the box.) The services necessary to exporters are:

—Intelligence about the buyers, the economies and the foreign-exchange situations of the buyers' countries;

—Arrangements for the transfer of funds, including release of funds by the importer's central bank if there are exchange controls; discounting; and communication between the exporter's and the importer's banks.

—Provision of credit to the buyer by a commercial bank, a nonbank finance company, an international organization, or through money-market facilities. Some exporters extend credit on their own, just as some larger exporters and large banks self-insure against credit risks.

—Assembling and forwarding appropriate documents, a function in which banks are an important channel.

Organizing for Export Sales

Many of the 95 responding companies make use of more than one type of organization, with two-thirds reporting an export division or department within the company:

<u>Organization</u>	<u>Number of Firms (multiple responses)</u>
Export division or department within company	67
U.S. subsidiary corporation	26
Combination export manager	16
Export trading company	8
Other	17
	134

The second most frequently mentioned organizational format is a U.S. subsidiary, set up especially to engage in export transactions. In recent years, some of these subsidiaries have been set up as a response to the growth in countertrade. As more buying countries require that a supplier buy an equivalent amount of that country's goods and as countertrade arrangements become increasingly complicated, managing such trade can require very highly specialized skills.

Companies with smaller dollar volumes of exports frequently mention the combination export manager (CEM) as their organizational arrangement for exporting. CEM's provide a range of services that include establishing links with foreign buyers, reducing financial and other risks, providing documentation services, and arranging for the financing and shipping of merchandise.

Export trading companies (ETC's) are organizations registered under the Export Trading Act of 1982. Under this statute: (1) Companies may band together in what might be termed "export cartels"—but with immunity from U.S. antitrust laws; and

Sources of Information, Part I

The first questionnaire dealt primarily with the extent of the companies' export activities, their approach to minimizing export risks, the nature of the financial services they offer to foreign customers, and the institutions and agencies they use to help them in these tasks. Most of the questionnaires were answered by people with the titles of export manager or export director or variations thereof. Some had the rank of vice president.

Responses were received from ninety-five companies currently engaged in exporting. Of these, 57 are durable goods manufacturers; 25 manufacture nondurables; and the rest are suppliers of diversified products, distributors of manufactured parts, equipment and engineering service companies.

The responding companies represent a wide range of size categories, as measured by annual sales:

<u>Annual Sales</u>	<u>Number of Firms</u>
\$5 billion or more	11
\$1 billion – \$5 billion	15
\$500 million – \$1 billion	7
\$100 million – \$500 million	28
Less than \$100 million	34
	95

Roughly half of these exporters depend on foreign markets for 10 percent or more of their total sales:

<u>Exports as Percent of Total Sales</u>	<u>Number of Firms</u>
60-70%	1
50-60	3
40-50	2
30-40	8
20-30	12
10-20	19
0-10	44
Less than 10%	6
	95

(2) Banks are permitted to own businesses formed primarily for the purpose of exporting. ETC's have been in existence for too short a time to make any judgment as to why there are so few of them.

Among the other organizational formats reported are: (1) domestic division-level responsibility for exports; (2) a sales force organized by geographic regions; (3) export associations; (4) assignment of export-management functions to the company's sales manager; and (5) DISC's (Domestic International Sales Corporations).

Problems in Financing Exports

Among the problems that face exporters is that of various risks. In normal, domestic transactions, it is the purchaser's creditworthiness that has to be analyzed and assured. In

international transactions, there are also the problems associated with currency and foreign-exchange controls, and with the economic and political stability of the buyer's country.

More usual problems are related to finding the appropriate method of payment (open account, letter of credit, or sale under collection) and negotiating competitive terms of sale for various countries. These arrangements may be more complex than those the seller is accustomed to negotiate in its own country, but they are familiar. It is the unusual type or degree of risk associated with exporting that makes this a rankling problem for financial managers.

Controlling Risk

Credit risk can be reduced by careful screening of buyers, tightening terms and conditions of sale, and use of export-credit insurance. As Table 1 indicates, credit risks are not perceived to be extremely high, although they are seen as riskier than those encountered in domestic sales.

When the responses are grouped on the basis of the respondents' most important regional export markets, it appears that:

- Among firms for which *Western Europe* is the primary export market, a high concentration considers that credit risks are moderately greater than in domestic business.
- Among firms for which *Latin America* is the primary export market, a high proportion considers that currency risks are much greater than in domestic business.
- Among firms for which *Latin America* is the primary market, there is also a marked tendency to consider that political risks are moderately great.
- Currency risks are not perceived to be as acute a problem in the *Far East* as in other parts of the world.

Currency risks can be reduced by hedging in the forward market; by use of exchange-rate option provisions in the original sales agreement (e.g., unit prices can be adjusted to compensate for adverse shifts in the rate of exchange); or by submitting the invoice in the exporter's currency. Political risks include a freeze on transfers of foreign exchange, as well as government changes that are unfriendly to the exporter. Such risks can be reduced by the purchase of appropriate insurance or, in the case of letter-of-credit transactions, by having a bank in the exporter's country confirm the letter of credit. Such confirmation assures pay-

Table 1: Exporters' Perceptions of Relative Severity of Credit, Currency and Political Risk

Perception of Export Sales	Credit	Currency	Political
Much more risky	13	40	39
Moderately more risky	37	36	30
Same degree of risk	21	7	10
Moderately less risky	12	4	4
Much less risky	6	2	1
Total Responses	89	89	84

ment to the exporter if the buyer's bank is unable to make dollar (or other hard-currency) payment. Table 2 summarizes the measures used to reduce risk and the rankings (1 = most important) of their importance.

Export Credit Insurance

Of 89 respondents who answered on this point, 26 use export-credit insurance; the majority do not. The companies using this service were asked to evaluate their experiences with three well-known U.S.-based insuring and guaranty institutions Export-Import Bank (EXIMBANK) Foreign Credit Insurance Association (FCIA), and the Overseas Private Investment Corporation (OPIC). Chart 1 summarizes these responses.

Financial Functions

Selling a company's products abroad entails some specialized financial activities. To a great extent, these also exist in domestic business, but they tend to be considerably more complicated in exporting. One result of this complexity has been the development of specialized services to assist exporters. These services are involved in obtaining information, transferring funds, establishing credit terms, and preparing documents.

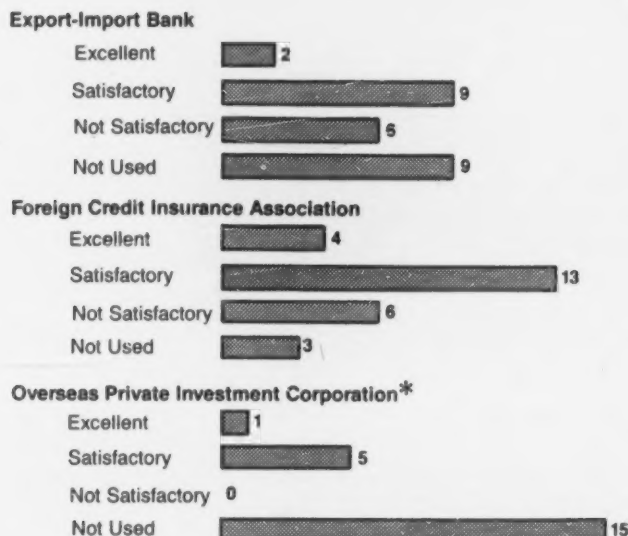
Obtaining Information

The types of information U.S. exporters need is related to the risks they perceive. They need to know about the credit status of customers, possible delays in payments, foreign-exchange restrictions, and the political and economic stability

Table 2: Methods Used to Minimize Export Risks and Ranking as to Importance (89 Companies)

Method	Rank					Total Mentions
	1	2	3	4	5	
More rigorous terms of sale	49	24	4	-	-	77
More searching evaluation of customer's credit standing	19	31	12	2	1	65
Credit insurance	8	9	9	5	3	34
Political risk insurance	1	4	8	12	3	28
Use export trading company	2	2	4	3	6	17
Other	9	3	1	-	-	13

Chart 1.
**Exporters' Evaluation of
Export Credit Insurance Suppliers**
(Responses of 26 Companies)



* There were only 21 responses to this question.

of the buyer's country. These sources include the organizations shown in Chart 2 and specialized commercial credit reports, analyses of risk by country, and International Monetary Fund (IMF) data.

Because careful evaluation of their customers' credit standing is one of the principal means of minimizing the risks of selling in foreign markets, the respondents were asked to indicate the sources of credit information on which they rely and to evaluate them. U.S. credit-rating agencies and banks and the exporting firms' own foreign affiliate appear to be the most used and the most satisfactory.

Transferring Funds

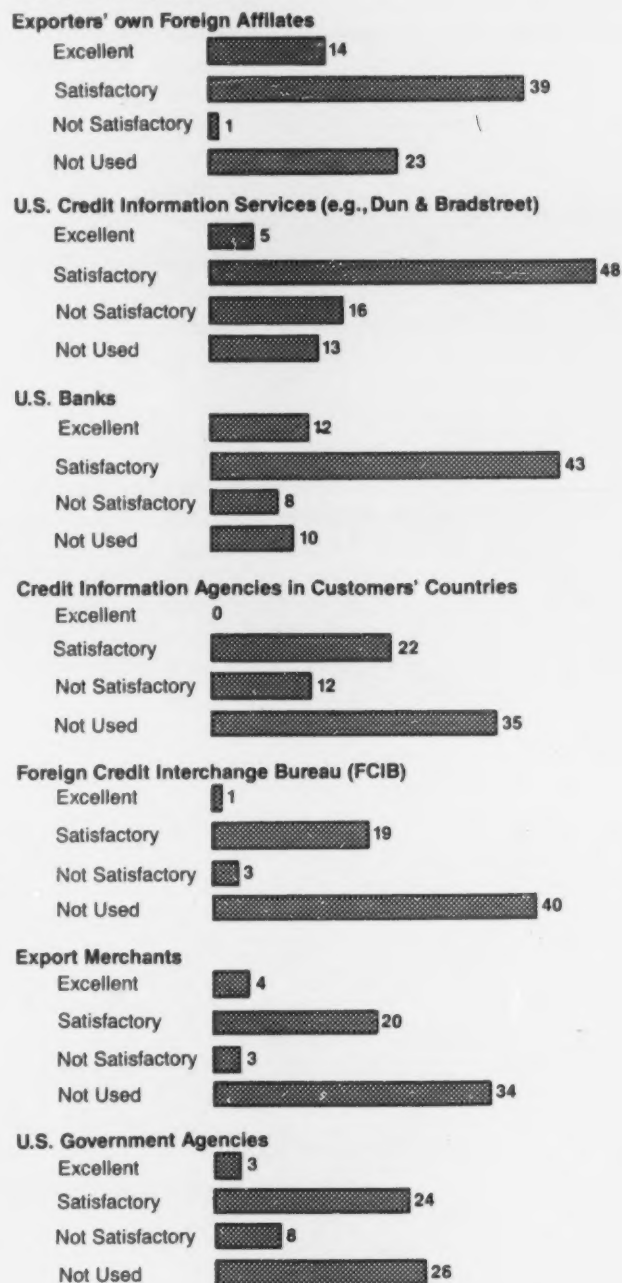
International monetary transfers are not as predictable as those made domestically, especially with respect to the timing of payments. In the absence of a central settlement mechanism, international money transfers are carried out through a network of correspondent-bank relationships.

Many countries have enacted laws or imposed regulations to protect their currencies. This often involves no more than a requirement to report international transactions to the central bank. However, in some countries, every import or export must be authorized before a contract is signed, and every payment must be made under a specific license issued by the central bank.

The regulation of foreign-exchange markets is an important concern of U.S. firms that export. In countries where the currency is not convertible, a bank may be able to buy foreign

Chart 2.
**Exporters' Evaluation of
Sources of Credit Information**

Source of Information:



Note: In addition to these sources, a few respondents also mentioned U.S. creditors, foreign distributors, competitors, and U.S. multinational companies. They all received either excellent or satisfactory evaluations.

currency from the central bank—provided the transaction is properly documented. Channeling all exchange transactions through such a single agency can, of course, cause delays.

Wide variations in the efficiency of banks from one country to another create another potential problem. In many less-developed countries, for example, there is a shortage of trained personnel. By contrast, the banks in Scandinavia are reported to be highly efficient although international transactions are strictly controlled in those countries. Because of the variety of problems related to banking and foreign-exchange and currency regulations, many exporters rely heavily on their domestic banks to effect money transfers. The following is a representative, but not exhaustive, list of money-transfer services of commercial banks:

- (1) Buying and selling foreign currencies and making remittances;
- (2) Collecting funds and drafts from foreign customers;
- (3) Opening accounts in their own foreign branches (or other banks abroad) in which their customers can deposit the proceeds of export sales;
- (4) Discounting drafts.

Payment Methods

The companies in this survey offer a variety of methods of payment to their foreign buyers. Eighty-six of the respondents furnished information about these terms. As might be expected, most offer several options (Table 3).

The most frequently mentioned combinations are: (1) letter of credit, open account, and cash; and (2) open account, letter of credit, and collection. As the table also indicates, open account and letter of credit are the most often used and are preferred.

Only four firms report that all their foreign sales are paid for by the same method: Three of these use letters of credit; the other uses open account. Eighty-five percent provide only short-term credits (maturity of one year or less); only seven percent provide credit for three years or more.

Twenty-eight of the seventy-three firms commenting on this point indicate that there are differences in the maximum maturity of credit they extend to customers in different parts of the world. Some base maturities on what the buyer's country requires. There is also a tendency to follow whatever practice prevails in the industry.

Table 3: Credit Terms and Payment Mechanisms (86 Exporters)

Method	Mentions	Percent of Total Sales			
		0-25%	26-50%	51-75%	76-100%
Letter of credit	80	33	22	12	13
Open account	75	23	24	14	14
Cash	43	36	4	1	2
Collection	29	22	6	1	0
Supplier credit	11	11	0	0	0
Other ¹	12	0	0	0	0
	250				

¹Includes sight drafts and time drafts drawn on the buyer.

Another question in this area had to do with interest charged on the credit extended to foreign buyers. Exactly half of the 78 respondents offering information about this issue charge no interest; about a third charge an interest rate equivalent to (or less than) the seller's borrowing cost. Only 11 percent charge an interest rate greater than the seller's borrowing cost.

Documentation

Documents of various kinds are required in foreign-sales transactions. In many cases, they are essential for collecting the amount due and in transferring title to merchandise. Documents are also required for customs clearance and to satisfy port-of-entry and port-of-exit regulations.

Sales contracts frequently specify the documents necessary for a given transaction. Those most frequently required are: the draft, the commercial invoice, the bill of lading, and the insurance certificate.

Financial Services

As has already been indicated, a number of organizations and institutions have developed specialized services to assist exporting companies. The principal suppliers of these services are commercial banks, export merchants and managers, institutions sponsored by the United States government and by the insurance industry, and agencies of some state governments.

Commercial Banks

Close to 200 large- and medium-sized banks in the United States offer a selection of export-sales financial services. The responding companies were asked about their use of these services, and their experience with them. The results are summarized in Table 4. Five respondents supplied information about various other services provided by their commercial banks: Two named letters of credit (rated excellent); one mentioned credit reporting (rated not satisfactory); one referred to local currency loans (satisfactory); and one cited satisfactory experience with the scheduling of merchandise shipments.

Export Merchants and Other Organizations

The financial services provided to exporters by commercial banks are also offered by other organizations. For example, export merchants, export trade houses, and combination export managers (CEM's) also play important roles in financing exports. The respondents were asked to indicate the extent of their use of such services and to evaluate them. Table 5 presents a summary of the results.

In comparing these judgments with those of commercial banks, two things stand out: First, the responding companies use the bank services more than those offered by other organizations. Second, smaller proportions of respondents rate these services positively (excellent or satisfactory) when they are provided by nonbank institutions.

Table 4: Rating of Commercial Banks' Services (multiple responses)

Service	Rating			Do Not Use
	Excellent	Satisfactory	Not Satisfactory	
Processing and forwarding documents	15	55	5	6
Foreign-exchange services	15	32	1	29
Prompt payment to exporter	9	35	6	21
Loans to foreign customers	5	22	7	33
Other ¹	2	3	1	0

¹Includes letter of credit, credit reporting, and freight forwarding.

Table 5: Rating of Services Provided By Export Merchants, Export Trade Houses, and Combination Export Managers

	Rating			Do Not Use
	Excellent	Satisfactory	Not Satisfactory	
Prompt payments to exporter	5	18	0	45
Provide credits and loans to foreign customers	0	10	3	49
Foreign exchange services	0	8	1	52
Processing and forwarding documents	3	21	0	41
Other	0	2	0	31

One recent innovation in financial services for exporters is the packaging of trade credit and credit insurance. This development appeared in 1982 with the start of the Trade Finance Corporation (TRAFICO), a packager of funds formed by the joint efforts of American International Group (AIG), a large export-credit insurer, and Salomon Brothers, a major investment-banking house. AIG insures the export credit, while Salomon Brothers underwrites the investment in the credit. Since its inception, the company is reported to have assumed commitments of about \$1 billion.

Another firm that has entered this field is the New York-based Globex International Credit Corporation. Globex assists its clients in locating the most favorable terms for credit and insurance coverage on export transactions.

Federal Government and Industry-sponsored Services

Certain institutions sponsored by the U.S. government also provide services useful to exporters, as does the Foreign Credit

Insurance Association, the creation of a group of private insurance companies. These institutions principally supply credit and provide insurance against the various risks already described. The most prominent of these organizations are the Export-Import Bank (EXIMBANK), the Foreign Credit Insurance Association (FCIA), the Private Export Funding Corporation (PEFCO), and the Commodity Credit Corporation (CCC).

The respondents were asked to comment on their familiarity with these institutions and their use of the services offered (Table 6). As the table shows, PEFCO and the CCC are least well known. The low rate of familiarity with CCC is probably explained by the specialized commodity orientation of that organization.

Although most of the respondents are aware of the other agencies, they make relatively little use of them. The nature and the manner of operations of these institutions may provide the explanation for this. For example, some exporters say that the availability of EXIMBANK funds is limited. In addi-

Table 6: Use of Services Offered by Specialized Government-Sponsored and Industry-Sponsored Institutions

	Number that Use Service	Number that Do Not	Number Unaware of Services
Export-Import Bank (EXIMBANK)	24	57	5
Foreign Credit Insurance Association (FCIA)	23	54	4
Overseas Private Investment Corporation (OPIC)	12	61	9
Private Export Funding Corporation (PEFCO)	7	60	13
Commodity Credit Corporation (CCC)	3	64	12

tion to providing direct loans from its own resources to finance U.S. exports, EXIMBANK provides guarantees to commercial banks that provide such services. It also offers export-credit insurance that is administered in cooperation with the Foreign Credit Insurance Association for short- and medium-term transactions, lines of credit to financial institutions, and discount loans to commercial banks.

More than 50 commercial property and liability insurers make up FCIA. It insures against commercial credit risks and political risks. FCIA operates under the sponsorship of the Export-Import Bank, which bears the ultimate losses resulting from war, revolution, import restrictions, currency blockage, cancellation of import licenses, expropriation, and similar political hazards. Several years ago, it was reported that the FCIA insurance program covers only a small portion of U.S. exports.¹ The companies in this sample did not offer reasons for not using FCIA's services, but the following are believed to be important factors:

(1) FCIA is not very flexible and does not respond quickly to exporters' needs. U.S. exporters often need an immediate answer concerning the availability of credit insurance.

¹S.M. Huszagh and M.R. Greene, "FCIA: Help or Hindrance to Exports?" *Journal of Risk and Insurance* (College of Business, University of Georgia, Athens, Georgia 30602), June, 1982, pp. 258-259.

(2) Human-rights considerations remove some countries from consideration by FCIA.

(3) More competitive insurance rates may be required because FCIA's foreign competitors are aggressive operators, and because the governments of other industrialized nations are eager to promote exports by means of low-cost export-credit insurance, as well as by low interest rates on export credits.

As for OPIC, loan-investment-guaranty services are not available on a full global basis but are restricted to countries with which the United States has negotiated special investment treaties. Thus, the U.S. exporter would have to be selling to a buyer in a country with which the United States has such a treaty if it is to make use of OPIC's coverage against political risk.

Agencies of State Governments

State governments are a major new entry in the field of export credit. As of early 1985, 11 states had the legal basis to establish programs to assist exporters: (Colorado, Illinois, Indiana, Louisiana, Minnesota, Missouri, Ohio, South Carolina, Tennessee, Washington and Wisconsin.)

These programs operate principally by discounting banks' export credits and providing working capital.

Part II: Tax Incentives for Exporters

The entire problem of the present position of the United States with respect to exports is beyond the scope of this paper. However, the attempts to encourage U.S. companies by offering tax incentives to exporters is of particular concern to financial managers.

The Revenue Act of 1971 established a mechanism for the purpose of encouraging exports. It permitted the establishment of paper subsidiaries—Domestic International Sales Corporations, usually called DISC's. The principal tax feature of these organizations was the provision that a large share of the income tax that would normally be due on their earnings was allowed to be deferred until the earnings were distributed to the parent company. Many U.S. companies responded to this incentive; a large number of DISC's were established; and billions of dollars of income-tax liabilities have been deferred.

In view of the massive trade deficits of the United States and the noncompetitiveness of many of its products, it is hard to conclude whether or not DISC's have been successful in achieving their goal. Three of four executives providing information for this part of the study indicate that their DISC's have not lived up to the expectations originally held for them. The feeling among those who commented on this is that the poor competitive position of many of the nation's products requires other remedies—remedies that go beyond tax incentives for exporters. (See box for information on how these data were gathered.)

Successful or not, trading partners of the United States grew increasingly critical of the DISC legislation, complaining that the tax advantage enjoyed by a DISC was nothing more than a disguised export subsidy and, as such, violated the antisubsidy rules of GATT (the General Agreement on Tariffs and Trade). These criticisms were voiced despite the fact that many of these countries allegedly subsidize their own exports in various ways, such as by subsidizing export credits.

In any event, Congress abolished the old DISC in 1984 (as part of the Deficit Reduction Act). At the same time, this legislation forgave all of the income taxes—estimated at more than \$13 billion—that had been deferred by U.S. firms under the 1971 legislation. The rationale for forgiveness of the deferred taxes was that exporters were entitled to be compensated for their efforts to build up exports, as Congress had intended. Some critics, in and out of Congress, however, objected to the forgiveness provision as an unjustified windfall for large exporters.

In the 1984 legislation, Congress also authorized a new format through which exporters could transact their overseas business and receive some tax advantage: the Foreign Sales Corporation, or FSC. Unlike DISC's these new subsidiaries are required to be based overseas. Instead of deferring the income tax on their earnings, up to 15 percent of the income tax owed by an FSC is immediately waived.

Sources of Information, Part II

This questionnaire had as its purposes to review the experiences of U.S. companies with DISC's; to examine how these companies were handling the accounting problems associated with phasing out those subsidiaries, specifically accounting for the forgiven taxes; and to get some idea of plans for establishing FSC's.

The questionnaire was distributed and the data gathered between the passage of the Deficit Reduction Act of 1984 and the expiration of the old DISC legislation at the end of 1984.

A total of 167 companies responded to the request for information. In most cases, this was provided by people with the titles of manager or director of taxation. Some were treasurers or assistant treasurers who had heavy responsibility for tax management.

Their principal lines of business are: 66% durable goods manufacturing; 17% nondurables manufacturing; 17% other. The largest group among the "others" consisted of export-management firms; the remainder were engineering and service companies, distributors, exporters and agricultural producers.

Almost half of the cooperating companies are of medium to small size, as measured by annual sales. However, larger companies were also represented, as the following tabulation shows.

<u>Annual Sales</u>	<u>Number of Companies</u>
More than \$5 billion	8
\$1 billion – \$5 billion	23
\$500 million – \$1 billion	22
\$100 million – \$500 million	35
Less than \$100 million	79
	167

It is not strictly accurate to say that the DISC has been abolished. U.S. exporters still have the option to establish a new, so-called interest-charged DISC. These new DISC's will be allowed to defer part of their annual income taxes, but they must pay interest (at Treasury-bill rates) to their parent companies on the amount of tax that is deferred. Early reaction to this new tax-incentive legislation (that went into effect on January 1, 1985) appears to be that it is less favorable to exporters than the former DISC system.

Experience with DISC's

Among the 167 responding companies, 155 operated at least one DISC at the time of the survey; 36 of these operated two or more. The principal reasons given for the existence of multiple DISC's are:

- Companies were acquired that already had a DISC;

- Separate DISC's were formed to cover different market segments;

- To provide for different fiscal years;
- To reduce the risk of having a DISC disqualified;
- To switch from a cash-basis DISC to an accrual basis.

The 155 firms also reported substantial use of this mechanism to effect exports, as the following tabulation shows:

<i>Percent of Exports Through DISC's</i>	<i>Number of Companies</i>
Over 75%	134
50% - 75%	10
25% - 50%	5
Under 25%	6
	155

The principal reasons cited for only slight use of DISC's are:

- The companies export engineering and construction services, the income from which is not subject to the tax-deferral DISC provisions.
- There was a need to retain foreign-source income to take advantage of foreign tax credits.
- DISC presents too many accounting problems.

Although most of the respondents made extensive use of DISC's, the preponderant attitude is that these organizations were not absolutely essential to exporting success—even though they helped their sponsors to compete. One-fifth, however, do regard the DISC as absolutely essential to remain competitive. (See Table 7.)

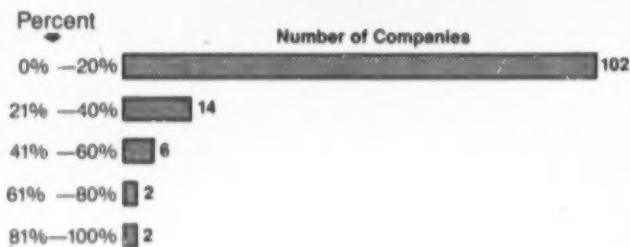
Interest Income of DISC's

Because of their ability to defer payment of U.S. corporate income taxes, some DISC's have been able to accumulate funds which they invested and on which they earned interest. Based on this sample, however, it appears that the opportunity to generate such interest income has not been a major source of revenue in most cases. (See Chart 3.)

Table 7: Importance of DISC to Exports

<i>Contribution of DISC</i>	<i>Number of Times Reported (multiple responses)</i>
Adds to ability to compete, but is not absolutely essential	89
Increases net return on export operations	92
Adds to liquidity of company	74
Provides financial flexibility	51
Absolutely essential to remain competitive	31
Other	3

**Chart 3.
Interest Income as a Percent of
Total DISC Income**



DISC Assets

Receivables from export customers are the most important assets held by DISC's. Table 8 summarizes the responses with respect to types of assets and their share in the total assets of the DISC's reported on.

Phasing Out DISC's

When companies with old DISC's phase them out, they face some major accounting decisions. Managements of some companies did not defer the income tax on DISC earnings because they did not want to postpone the recognition of the related earnings indefinitely. In such cases, DISC income was simply reflected as current income. It is important to distinguish between these firms and those that elected to report deferred taxes each year on the untaxed portion of DISC income. The current financial reporting of companies that *did not* accrue deferred taxes will be unaffected by the 1984 legislation.

Companies that *did* record deferred taxes, however, will now be required to recognize their accumulated deferred taxes as current income because these taxes were forgiven by the 1984 legislation. The Financial Accounting Standards Board (FASB) has issued a ruling that requires companies to report

Table 8: Assets Held by DISC's (multiple responses)

<i>Type of Asset</i>	<i>Number of Times Reported</i>
Accounts receivable from export customers	111
Notes of Private Export Funding Co.	47
Loans to affiliates	42
Notes of export customers	5
Other (including interest and commissions receivable, cash, inventory, minority interest in foreign company's stock)	27

the reversal of the deferred taxes as current income in the first financial statements issued after July 18, 1984.² This accounting treatment increases current reported income, but has no effect on a company's cash flow.

In this survey, 51 of the 155 companies that operated DISC's report that they have recorded deferred income taxes. Of these, 33 expect to report the reversal of these deferrals as current income in accordance with FASB Technical Bulletin 84-2. Ten of the other firms plan to transfer these deferred taxes to retained earnings, rather than to report them as current income. Eight of the respondents indicate that financial accounting treatment had not yet been determined, or that they intend to continue their present accounting until completion of IRS examinations.

The questionnaire attempted to find out what effects, if any, the tax relief might have on companies' capital expenditure or other investment plans. The responses of those providing this information are summarized in the tabulation:

<i>Expected effects</i>	<i>Number of Companies</i>
Reduce planned borrowing	34
Increase dividend distribution	17
Increase capital spending	13
Increase R&D spending	13
None	12
None, no effect on cash flow	2

Foreign Sales Corporation Plans

The respondents were asked if their companies had plans to organize the new entities: Foreign Sales Corporations. Of 143 companies answering, 116 intend to do so.

One factor that seems likely to discourage some firms from setting up an FSC is that, unlike the DISC, the FSC *must* conduct its business outside the United States. However, an offsetting advantage of the FSC format is that a group of exporters can get together to form a jointly owned FSC, thereby easing the cost and other pressures on the individual sponsors that are associated with doing business abroad.

U.S. companies that are already selling in overseas markets through foreign subsidiaries or agents are in a position to satisfy the FSC requirements with little or no additional

operating costs. Respondents were requested to indicate the proportion of their foreign sales made through such agents. As the tabulation shows, more than a third of those answering this question generate half or more of their exports in this manner.

<i>Percent of Sales Made Through Foreign Agencies</i>	<i>Number of Companies</i>
0%	32
1-10%	11
11-20%	9
21-30%	11
31-40%	3
41-50%	9
51-60%	3
61-70%	4
71-80%	14
81-90%	12
91-100%	13
	121

Whether firms are in a position to extend their utilization of such services depends on the location of agents compared with the location of markets. If these do not match up, there could be substantial additional costs because of the foreign-location requirement for FSC's.

Changes in Export Activities

Companies that plan to organize an FSC were asked to identify what changes they anticipate in carrying out their export activities. Of the 110 providing information, 32 expect to increase their use of foreign agencies; 28 to increase their use of foreign affiliates; 20 to increase their use of both agencies and affiliates. The 30 companies that did not choose among these alternatives indicated that they expect that operating under FSC rules will bring increased costs (e.g., administrative expenses, operating an offshore office, expenses of establishing an offshore sales company, or additional tax department costs).

A small minority of the 110 respondents supplying information on this point indicate they are already operating overseas and will continue to do so; or they expect to operate as a small FSC; or they plan to set up a foreign office. In the latter case, their export procedures may be expected to change to comply with FSC regulations. A few firms are not yet certain how their export activities will be carried out, or whether their exports will be positively or adversely affected.

²"Accounting for the Effects of The Tax Reform Act of 1984 on Deferred Income Taxes Relating to Domestic International Sales Corporations," Technical Bulletin No. 84-2, September 18, 1984. Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905-0821.

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Current Issues in Human-Resource Management

by Lawrence Schein

Management Summary

- In this survey of nearly 600 major U.S. companies, senior human-resource executives single out *cost control of employee benefits* as their most pressing issue during the next one to three years.
- Other critical issues for human-resource management in the near term: productivity improvement; linking human-resource planning with the strategic business plan; changing the corporate culture.
- The thrusts toward health-care cost containment and productivity improvement are being led by companies with 10,000 or more employees.
- Executives perceive the human-resource function to be changing in one particular respect: greater involvement with the operations, decisions and strategies of the company's business.
- The majority of respondents believe that, in the near future, more merger-acquisition-divestiture activity and the accelerating introduction of new technologies—in production, marketing, distribution and administration—will have an impact on their companies.
- Nearly all executives queried expect productivity gains in the next few years, set in motion chiefly by the better use of human resources and the application of new technologies.
- More job opportunities will be available for managers and professionals than for clerks and production workers.
- Job opportunities for managers and professionals will be better in financial services than in manufacturing or public utilities.
- Financial services companies and nonunion firms are in the forefront in job analysis and bonus plans for middle managers and professionals.
- In the manufacturing industry, executives in the nondurable goods sector expect less diversification, fewer operations abroad, less introduction of new technology, and more merger-divestiture activities than their counterparts in durable goods.
- Human-resource employment levels are not expected to change between 1984 and 1986.

HUMAN RESOURCES PROGRAM

About This Report

Highlights of the 1986 survey of issues in the management of human resources were reported at the Board's Human Resources Outlook Conference in October, 1985. At the same time, these preliminary materials were sent to respondents in the nearly 600 companies participating in the survey. This Research Bulletin presents detailed findings, analyses and statistical data from the 1986 survey, including comparisons with the findings of the 1985 benchmark survey.¹

Methodology: The questionnaire for the present report was mailed to a senior human-resource executive in each of 1,339 large U.S. companies in May, 1985. In the great majority of instances, the questionnaire was addressed personally to the chief human-resource officer in the firm. The sampling group consisted of the 1984 *Fortune* 500 industrial companies, the 1984 *Fortune* 500 service companies, and 1985 Conference Board Associate firms not in the *Fortune* 500 ranks whose executives express interest in personnel topics. A total of 583 questionnaires were completed and returned, a response rate of 44 percent. The 583 cooperating companies reported ten million employees in U.S.-based facilities.

Sample: Several characteristics of the responding companies are shown in the table below. The responding sample is heavily weighted toward the largest companies (as measured by number of employees at U.S.-based facilities), as was the original sample. Fully 35 percent of respondents represent firms with 10,000 or more employees, with over half of the companies in the sample having 5,000 or more employees. The respondents are about equally divided between manufac-

turing and nonmanufacturing firms. Somewhat over 60 percent of responding companies report union membership among their employees in the United States. At nearly 20 percent of the firms, half or more of all employees are represented.

Statistical Note: Differences among human-resource issues and company characteristics were tested both for significance and strength of association. Those differences between groups that are singled out in the text—and in Tables 1, 2, 3, 6, 8 and 9 and Charts 3, 5, 6, 7, 9 and 10—are both statistically significant and meaningful. For ease of reference, the text simply refers to these relationships as "significant." To help interpret the results in this sample, the reader may use this rule of thumb: In reading across a row (of numbers or bars) for a sample of this size, a difference of at least 7 to 10 percent between or among groups or subgroups is statistically significant. In Table 1, for example, the relationship between two company characteristics—employment size and industry type—is quite strong ($p < .01$ by the chi-square test). Thus, financial services include a significantly lower proportion of very large companies than do the other industries. It is also evident that there are no significant differences among the other three industry groups in the proportion of very large companies.

¹The 1985 survey was circulated in May, 1984. The 1985 and 1986 surveys are similar, but not identical, in content. Respondents in both years were senior human-resource executives in major firms, but were not matched samples.

Characteristics of the Sample, 1986

<i>Company Size by Number of U.S.-Based Employees</i>	<i>Responding Company (N = 583)</i>
Smaller (under 1,500)	100%
Medium (1,500-4,999)	14
Large (5,000-9,999)	32
Very large (10,000 and over)	19
	35
<i>Industry Type</i>	100%
Durable goods	20
Nondurable goods	23
Public utilities ¹	16
Financial services	22
Other ²	19
<i>Extent of Unionization of U. S.-Based Employees</i>	100%
No union members	37
Under 20% in union	21
20% to 49% in union	22
50% or more in union	19
Unionized, but number unreported	1

¹Gas and electric utilities, communications and transportation.

²Mining, construction, wholesale and retail trade, nonfinancial services and a small number of companies where respondents checked "other manufacturing" instead of any of the specific two-digit SIC classifications from which the durable and nondurable categories were developed.

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Introduction

The 1986 survey of issues in human-resource management is a means by which The Conference Board assesses the "climate" of concern, change and challenge among senior corporate executives in the broad "personnel" field. This bulletin incorporates the principal findings of a survey for which data were gathered in the Spring of 1985.

The survey questions were designed to provide a human-resource outlook for the near future through identification of:

- major issues in the next one to three years;
- ways in which the human-resource function is changing;
- operational consequences of business, economic and social developments;
- programs and activities that have received major attention from executives in the recent past;
- programs and activities on which managers intend to devote substantial effort in the near term;
- differences in the perceptions of issues, operations and ac-

tivities by managers whose companies vary in employment size, industry, union representation and the size of the human-resource staffs.

The survey for 1986 is the second in a series. Because of widespread interest in the impact of downsizing on the human-resource function, questions were added this year about the numbers of full-time professionals in this field.

Companies that provide financial services tend to have fewer employees than firms producing goods or supplying public utilities. Nonunion firms have smaller work forces than the unionized companies. The great majority of responses from public utilities and manufacturers (of both durables and nondurables) indicate union representation; in contrast, financial services companies are almost entirely nonunion. These and other aspects of the interrelationships among company size, industry type, and union status among the responding companies are presented in more detail in Tables 1, 2 and 3.

Table 1: Differences in Employment Size, by Industry Type, 1986

	Industry Type			
	Durable Goods (N = 119)	Nondurable Goods (N = 136)	Public Utilities (N = 92)	Financial Services (N = 125)
<i>Company Size by Employment¹</i>	100%	100%	100%	100%
Smaller	14	14	9	12
Medium	33	25	36	44
Large	13	23	17	24
Very large	40	38	38	20

¹Smaller: under 1,500 employees; medium: 1,500-4,999; large: 5,000-9,999; very large: 10,000 and over.

Table 2: Differences in Unionization by Employment Size, 1986

	Company Size ¹			
	Smaller (N = 83)	Medium (N = 187)	Large (N = 107)	Very large (N = 198)
<i>Unionization</i>	100%	100%	100%	100%
Nonunion	65	49	32	19
Less than 20% in union	11	17	22	27
20%—49% in union	14	18	24	28
50% or more in union	10	16	22	26

¹Smaller: under 1,500 employees; medium: 1,500-4,999; large: 5,000-9,999; very large: 10,000 and over.

Table 3: Differences in Industry Type, by Unionization, 1986

Industry Type	Unionization			
	Percent of Employees in Union			
	Nonunion (N = 185) 100%	~20% (N = 80) 100%	20%-49% (N = 105) 100%	50% + (N = 95) 100%
Durable goods	16	32	31	32
Nondurable goods	14	50	41	24
Public utilities	8	9	25	44
Financial Services	62	9	3	0

Major Issues

Respondents were given a list of 24 specific issues and were asked to select the three anticipated as the *major concerns* confronting human-resource management in the next one to three years. Chart 1 shows each issue and the frequency of its selection as among the first three in importance by senior human-resource executives from the 583 companies.

It is interesting that no single issue is placed in the top three by a majority of respondents. The most important concern in the near term is control of benefits costs, cited by nearly half of respondents: In this response, as will be seen later, health-care costs are the primary target. The need to link human-resource planning to the strategic business plan, deemed of top importance by nearly 40 percent of respondents, is also one of the most widespread concerns for the human-resource function. Other items of major importance, given top-three standing by over one-fourth of responding executives, are productivity and change in the corporate culture. These are broad, basic organizational issues that affect the entire structure and purpose of the company.

Aside from the specific and very clear concern to contain health-care costs, human-resource executives appear to be taking the longer view. They are addressing general, more global issues of their companies' business(es) for the near term. Productivity improvement, culture change and more strategic human-resource planning also have longer-term considerations in implementation and in results. These responses suggest human-resource executives see themselves less in the role of support staff and more as participants in the making of business decisions.

This is perhaps why issues such as merit pay and performance, introduction of new technology, management development, training and employee participation are accorded less importance as issues than might be expected. It is not that they are unimportant, but that as specific functions, programs or developments, they are subsumed under more general, organizational, businesswide concerns. It is the longer view that gives specific issues less priority.

The data on the ranking of issues from the 1985 survey are not directly comparable, since several new items were added to the 1986 list. The earlier rankings, however, tended in the same direction. The three leading issues confronting human-resource

management in the earlier survey were controlling employee benefits costs (69 percent), improving productivity (50 percent) and changing the corporate culture (30 percent). Review of the two sets of findings suggests an increasing attention to human-resource planning and its connection to strategic planning.

Company Size, Industry Type, and Unionization

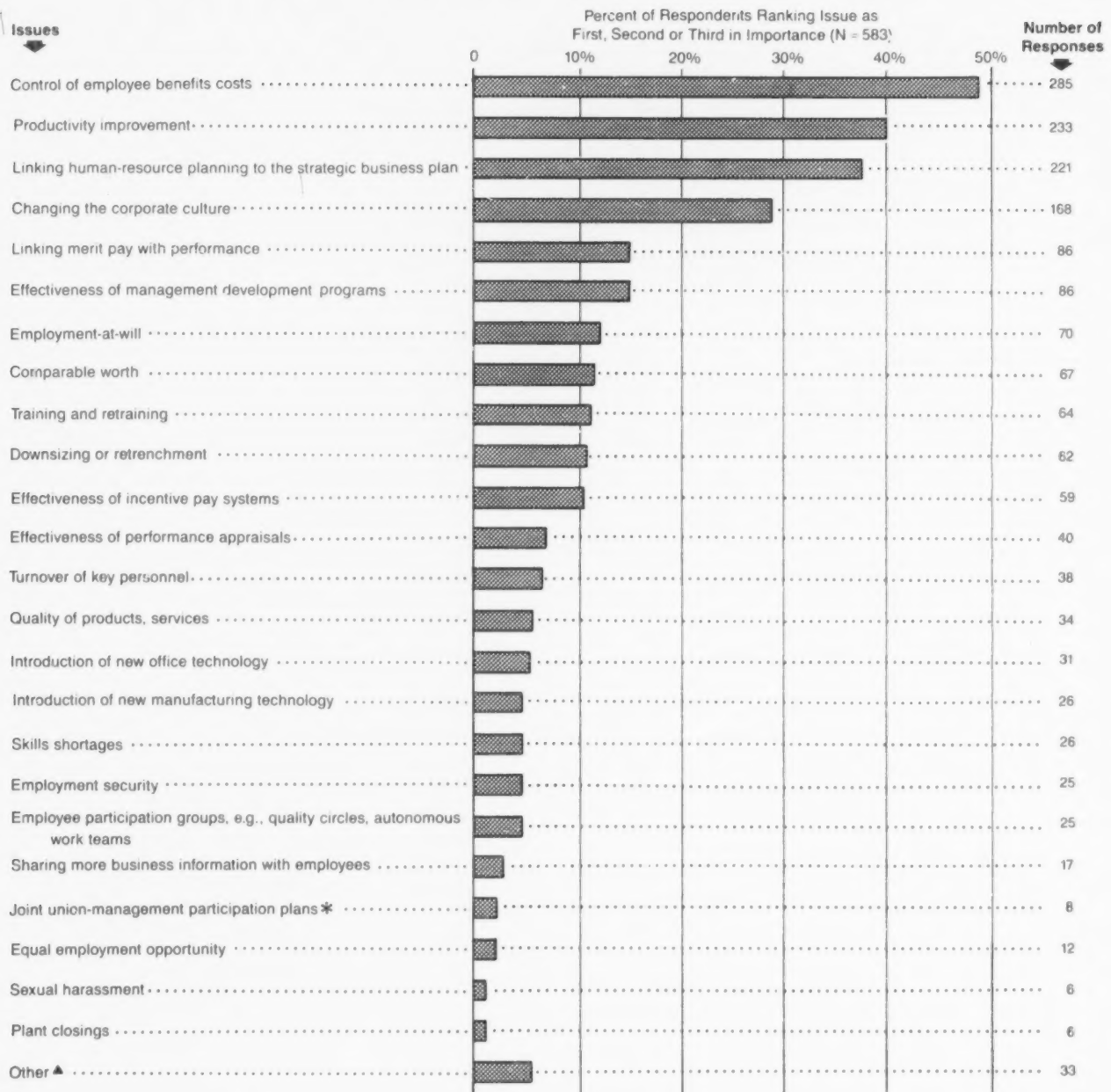
Perceptions of the importance of issues have been analyzed by the companies' employment size, industry type, and extent of employee unionization. On the whole, there were few significant differences. Company size is unrelated to the perception of issues. However, differences in industry type are strongly related to differing views of the importance of several issues for the near term, as noted below:

Issues	Percent in Each Industry Giving Top Ranking			
	Non-			
	Durable Goods	durable Goods	Public Utilities	Financial Services
New manufacturing technology	13	5	1	1
Incentive pay	2	4	6	23
Strategic HR planning	41	30	40	49

Respondents in durable goods industries see the introduction of new manufacturing technology as a top issue to a much greater degree than those in the other groups. Nearly one-fourth of financial services executives rank incentive pay systems as their top issue. Also, linking human-resource planning to the strategic business plan is emphasized more by financial services managers than by the other executives, although each group shows a sizable number of responses.

The degree of unionization makes for a significant difference in only one of the 24 issues: Incentive pay systems are mentioned most frequently among the top three by nonunion firms (16 percent). The significance of this issue then decreases steadily with increasing unionization of the work force.

Chart 1.
**Top Major Human-Resource Management Issues
 The Next One to Three Years**



* Base is the number of companies with union representation.

▲ Other issues suggested by respondents include succession planning, development of leadership skills, post-downsizing reorganization, advancement for younger employees and middle-management involvement.

Table 4: How the Human-Resource Function is Changing, 1986

Direction of Change (multiple responses)	Number of Responses	Percent of All Respondents (N = 583)
Getting closer to the business; more involvement with business decisions, planning, strategy	325	56
More consultative; helping or training line managers in HR functions	88	15
More professionalized, specialized, technical	78	13
Concern with profits, results, success	61	11
Concern with costs, cost effectiveness	59	10
Becoming more pro-active, less reactive	57	10
More productivity oriented	43	7
Coping with regulatory impact on business	23	4
Quality awareness	19	3
Involvement with unions	11	2
More forecasting activity, scanning	10	2

How the Human-Resource Function is Changing

By designating the human resources-strategic planning link as a top issue for the future, respondents demonstrate a strong interest in the entire business in which they are involved. This interest is even more clearly expressed in responses to an open-ended question about ways in which respondents perceive the human-resource function to be changing. As noted in Table 4, the one theme heavily emphasized is the greater involvement with the enterprise, and with its decisions and strategies. Business orientation is cited as the principal change by over half of all respondents.

Two general directions—the *strategic* and the *operational*—can be identified from respondents' perceptions of changes in the human-resource function. The strategic direction involves business decisions and long-term concerns. The operational direction involves more day-to-day, short-term concerns with performing a function, for example, consultation, cost effectiveness, forecasting or labor negotiations. The table below shows the classification of individual respondents by general direction of expected change.

Direction of Change	Number	Percent of	
		All Respondents	Respondents Answering (N = 474)
Strategic	325	56	69
Operational	149	26	31
No answer	109	19	—
Total	583	100	100

Some quotations serve to illustrate the perceived shift toward closer involvement in and greater knowledge of the business:

"The function is becoming broader gauged and more closely tied to the essence of the business strategy and operation."

A retailer

"More emphasis on strategic planning and the requirement that HR professionals know the business to become credible, participating members of the management team."

A diversified manufacturer

"HR is having more strategic impact on the enterprise; becoming much more business oriented. HR is now part of the mainstream of the business—planning, corporate 'direction,' strategic thinking."

An aircraft manufacturer

"Greater participation in the strategic planning and direction of the company, since effective personnel management is more and more seen as a source of competitive advantage."

A business equipment manufacturer

"HR is being more usually called upon for input to strategic organizational planning and change and, therefore, is becoming more directly accountable for its impact."

A financial corporation

"HR is developing a sharper understanding of its contribution to business success and, in the process, is becoming a 'less soft' function."

A lodging and restaurant service

"To make an effective contribution to the organization, HR will have to move to more comprehensive, less piecemeal, approaches that are more closely tied to the strategic business goals and, if anything, carry an even stronger human-values message."

A shoe manufacturer

"Human-resource professionals are taking a much more active role in determining and preparing for the strategic direction of businesses, large and small. Their participation, rather than just being tolerated, is now more actively sought in many companies."

A transportation company

"The human-resources function is showing more orientation to the needs of the business, to the quality of service to the client, to finding ways to increase employees' awareness of crucial business elements."

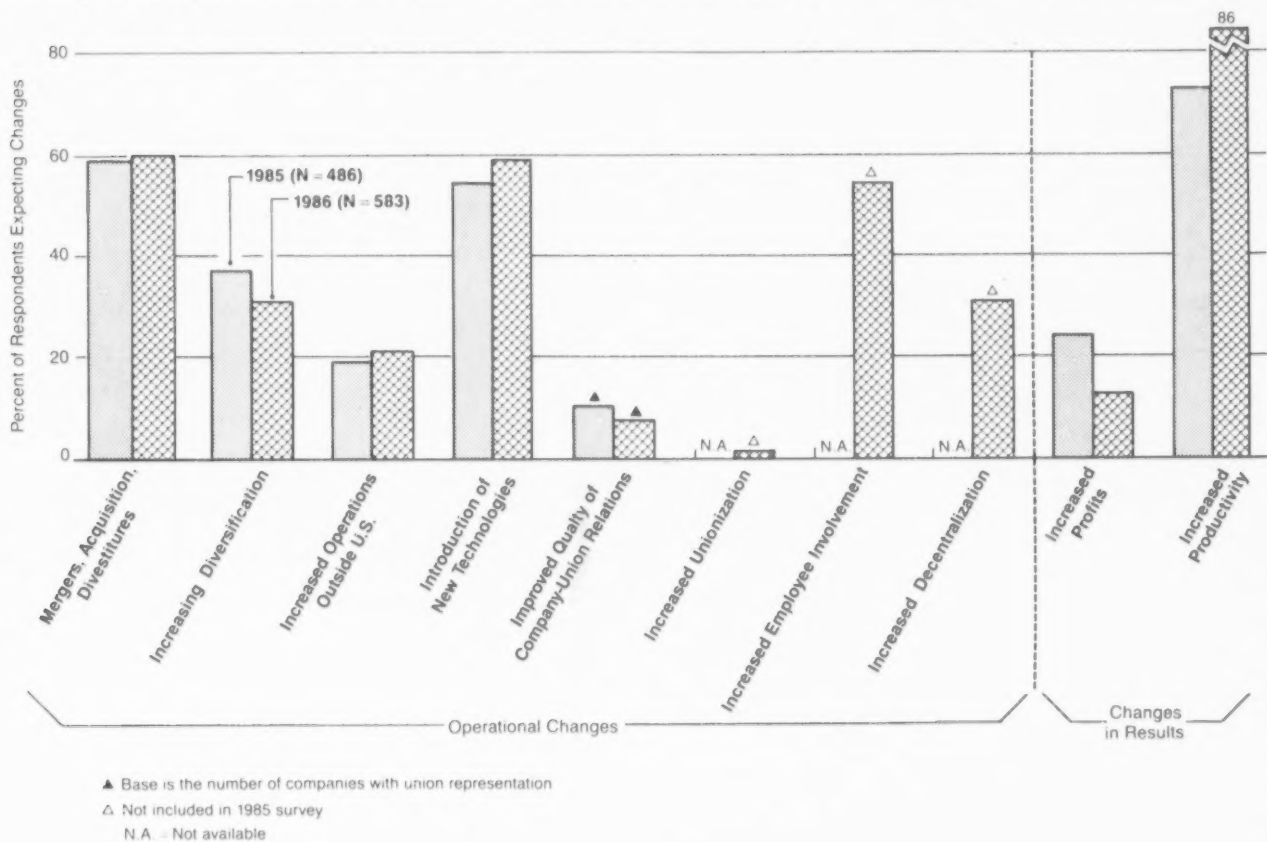
An insurance broker

"Human-resources is identified more with actual management of the company as against being a support function."

A communications equipment manufacturer

Chart 2

Changes in Operations and Results Expected in the Next One to Three Years; 1985 and 1986



There were no significant differences in the perception of the changing human-resource function by industry type or degree of unionization. Executives giving strategic responses represent very large companies to a greater extent than those giving operational types of responses.

Operational Effects of Business, Economic and Social Developments

Respondents were asked to indicate the consequences for their companies of business, economic and social developments in the coming one to three years. Expected changes in operations from such developments have strong implications for the content, magnitude and direction of human-resource activities. The lists of business operations and results used in the 1985 and 1986 surveys are shown in Chart 2, together with the extent to which respondents anticipate changes.

Three of every five respondents in both survey years expect mergers, acquisitions and divestitures to affect their businesses. An increase in merger activity indicates a major role for human resources in managing the integration of separate cultures into new systems. Over half of the executives in 1986 expect an increase in employee involvement in their companies. This is

consistent with the growing interest among major U.S. firms in more effectively using the experience and talent of workers through such vehicles as problem-solving groups, business teams, and autonomous work teams.¹ Substantial proportions of respondents in both survey years anticipate increasing business diversification, suggesting a continuing human-resource effort to develop entrepreneurial managers as companies seek new market advantages. Increasing decentralization of the business, expected by over 30 percent of executives in 1986, may create momentum for further decentralization of the human-resource function into operating units.

A majority of respondents in both years expect the introduction of new technologies into their businesses in the near term. In 1985, it was felt that the impact of new technologies would be experienced about equally in administration, marketing and distribution, and production. By 1986, however, somewhat more respondents (37 percent) believe that new technologies will have an impact on administrative tasks than anticipate such a development in marketing and distribution (29 percent), or production functions (32 percent).

¹For a description of these and other related techniques, see Chapter 2, "Designs for Change," in Harriet Gorlin and Lawrence Schein, *Innovations in Human Resources Management*, The Conference Board, Report No. 849, 1984.

Table 5: Factors Contributing to Anticipated Productivity Change, 1985 and 1986

Productivity Factors (Multiple responses)	Expecting Change			
	1985 Survey ¹		1986 Survey ¹	
	Number of Responses	Percent of Respondents (N = 486)	Number of Responses	Percent of Respondents
Better use of human resources	309	64	407	70
Application of new technology	249	51	347	60
Change in product design or product mix	70	14	121	21
Change in scale of operations	67	14	116	20
Employee concessions	a	a	40	7
Improved quality-control procedures	a	a	151	26

¹The 1985 survey was distributed in May, 1984, the 1986 survey was distributed in May, 1985.

^aNot included in the 1985 survey.

In both the 1985 and 1986 surveys, the vast majority of respondents anticipate changes in productivity. The reasons for expected productivity increases are indicated in Table 5. In both surveys, productivity gains are attributed primarily to the better use of human resources and, secondarily, to the application of new technology. Only a very few executives believe that employee concessions will lead to productivity improvement in 1986.

By attributing productivity gains chiefly to more effective human-resource management, and by voicing the need to become more knowledgeable and decisive in business strategy, senior human-resource executives place their function at the center of the corporate effort to raise productivity. Presumably, some of them expect that if the regard for the human-resource function increases on the part of those outside the function, larger allocations of corporate resources might be made available in productivity-related areas.

Company Size, Industry Type, and Unionization

Company size is not associated with differences in expected operational changes. Industry type, however, does account for a number of significant differences, as shown in Chart 3. Acquisition, merger and divestiture activity is expected to a greater extent in financial services and nondurable goods than in durable goods and public utilities. Increased diversification is expected by nearly half the financial services respondents in contrast to only one-fifth of the nondurable goods executives. In durable goods, increasing operations abroad are anticipated to a substantially greater extent than in the other industries. Among the more pronounced variations within manufacturing are the different anticipations of new technology introduction between executives in durable goods (74 percent) and those in nondurable goods (51 percent). Increased employee participation in the business is expected in durable goods and public utilities to a greater extent than in nondurable goods and financial services. Durable goods executives are most likely to expect quality-control procedures to play a role in raising productivity in the near future.

A further sharp distinction among industries is shown in Table 6. Respondents were asked to indicate the functional area or areas they anticipate will be *most* affected by the introduction of new technology into their business: Over 60 percent of durable goods executives respond with "production" compared to only 32 percent of respondents in nondurable goods. New technology is expected to affect marketing and administration to a greater extent in financial services than in the other industries.

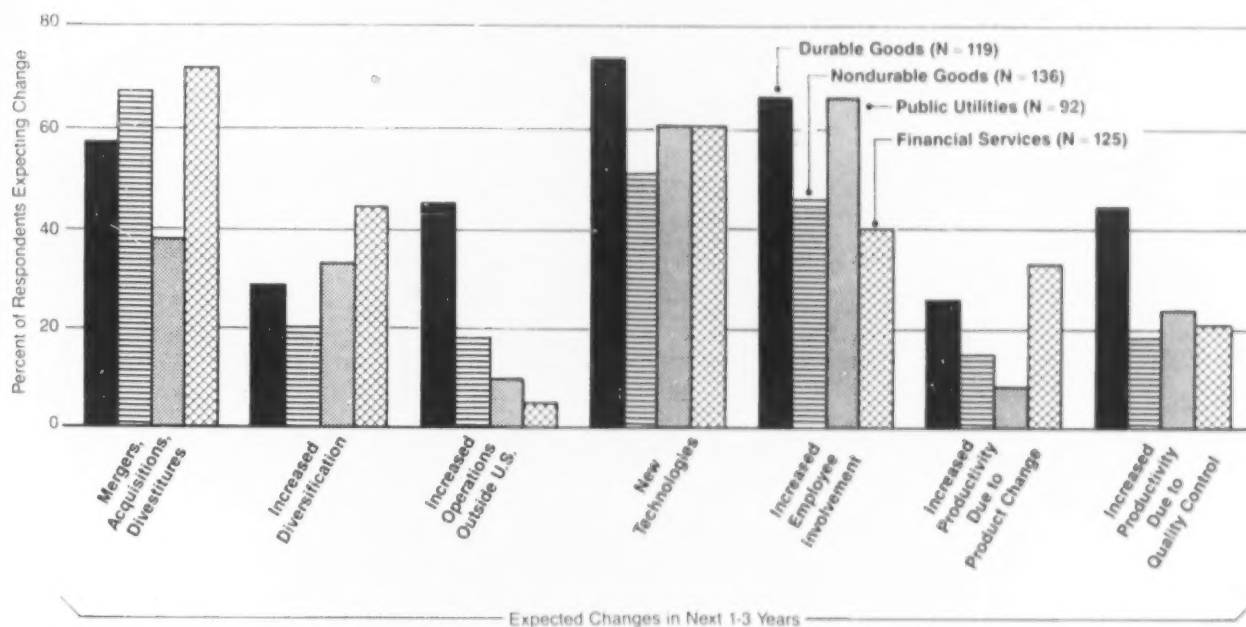
The variations within manufacturing seem systematic: Compared to durable goods companies, the nondurable sector expects to be subject to more takeover or breakup, less diversification, fewer operations abroad, less introduction of new technology into production, less employee involvement, and less productivity enhancement through quality control.

Two significant differences are found when extent of unionization is related to differences in expected changes in business operations and results, as the tabulation indicates:

Operation or Result	Percent in Each Group Expecting Change			
	Non- Union	Unionized Companies (Percent of employees in unions)		
		-20%	20-49%	50%+
Productivity stemming from product change	29	20	17	6
Company-union relationship	—	13	25	48

The chances of a change in product design or mix leading to a productivity increase declines with increasing unionization. It may be more difficult for management in highly unionized settings to obtain changes in work assignments and schedules required by modification in product design. Nearly half of executives in heavily unionized firms anticipate a change in the labor-management relationship, keyed, in part, to productivi-

Chart 3
Differences in Expected Operational Changes by Industry Type
(N = 472)



ty and employment-security issues in manufacturing. The direction of the change is unclear, however; respondents are about equally divided between those who expect improvement and those who expect deterioration in the relationship.

Human-Resource Activities and Programs: The Recent Past and Outlook For the Near Term

Respondents were asked to assess the impact of the issues, concerns and operational changes they had cited on their own human-resource activities. They were presented with a list of human-resource programs and activities typically found in varying combinations in today's workplace—covering work-force size and elasticity, compensation systems, employee benefits strategies, and other selected personnel practices—and were

asked to indicate the degree (none, minor or major) to which their companies have engaged in these activities during the past year and their expectation of the degree of activity in these areas over the next three years. A "major" emphasis was defined as appropriate for an activity deemed of fundamental importance to goal achievement. A "minor" emphasis was defined as appropriate for an activity that is not or will not be of strategic importance in achieving the firm's human-resource and business goals.

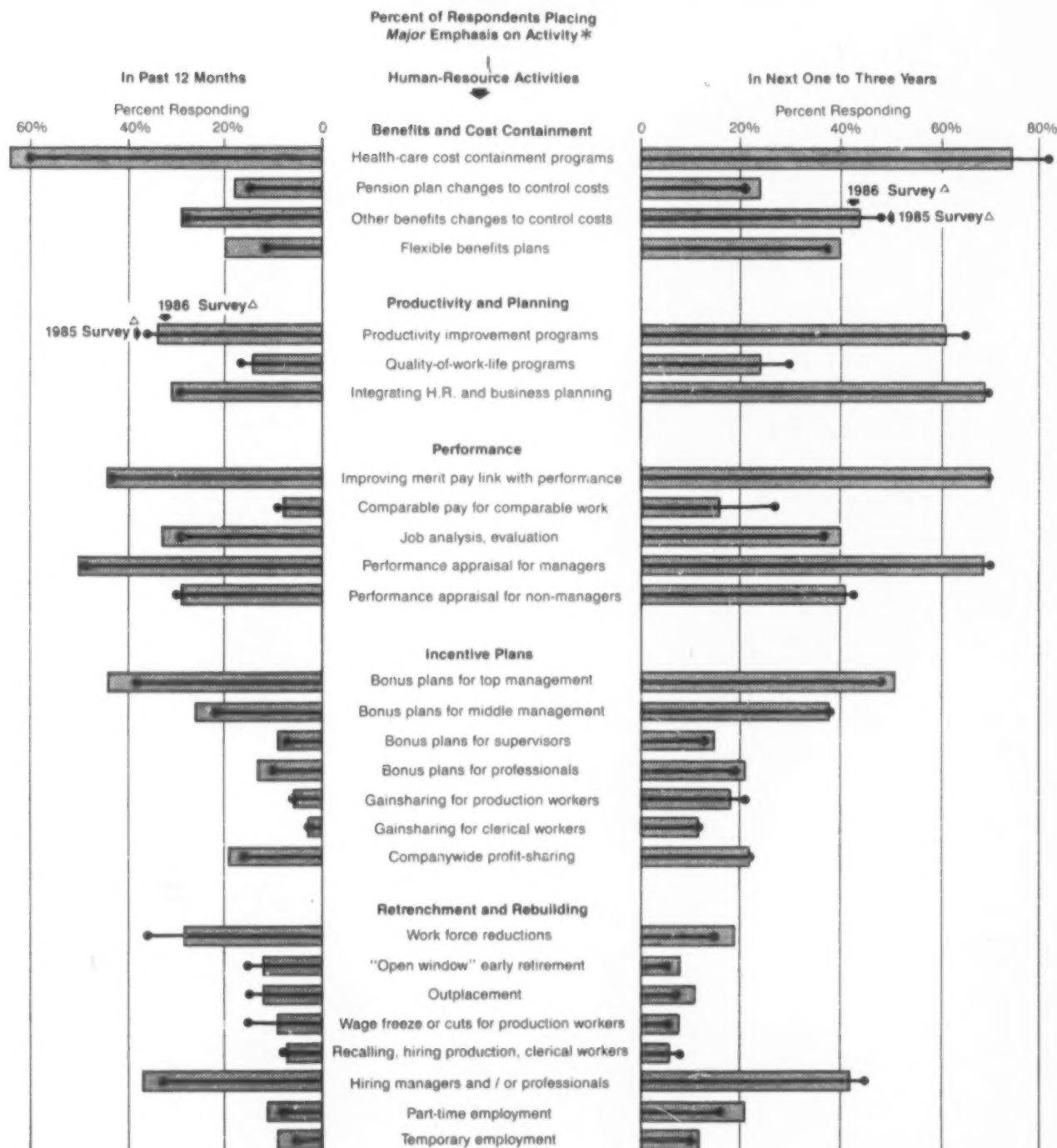
Table 7 shows the activities on which one-half or more of all respondents expect to place major emphasis in the next one to three years. Several of these important activities are also linked to significant human-resource issues. The three top issues—benefits-cost control, productivity improvement, strategic human-resource planning—will be reflected in specific programs commanding the major attention of human-resource ex-

Table 6: Differences in Impact of New Technology on Functions, by Industry Type, 1986

Functional Area Affected (Multiple responses)	Respondents Expecting New Technology Introduction			
	Industry Type			
	Durable Goods (N = 119)	Nondurable Goods (N = 136)	Public Utilities (N = 92)	Financial Services (N = 125)
	%	%	%	%
Production	62	32	25	16
Marketing, distribution	28	24	36	44
Administration	36	34	38	46

Chart 4.

Extent to Which Respondents Place Major Emphasis on Human-Resource Activities, 1985 and 1986

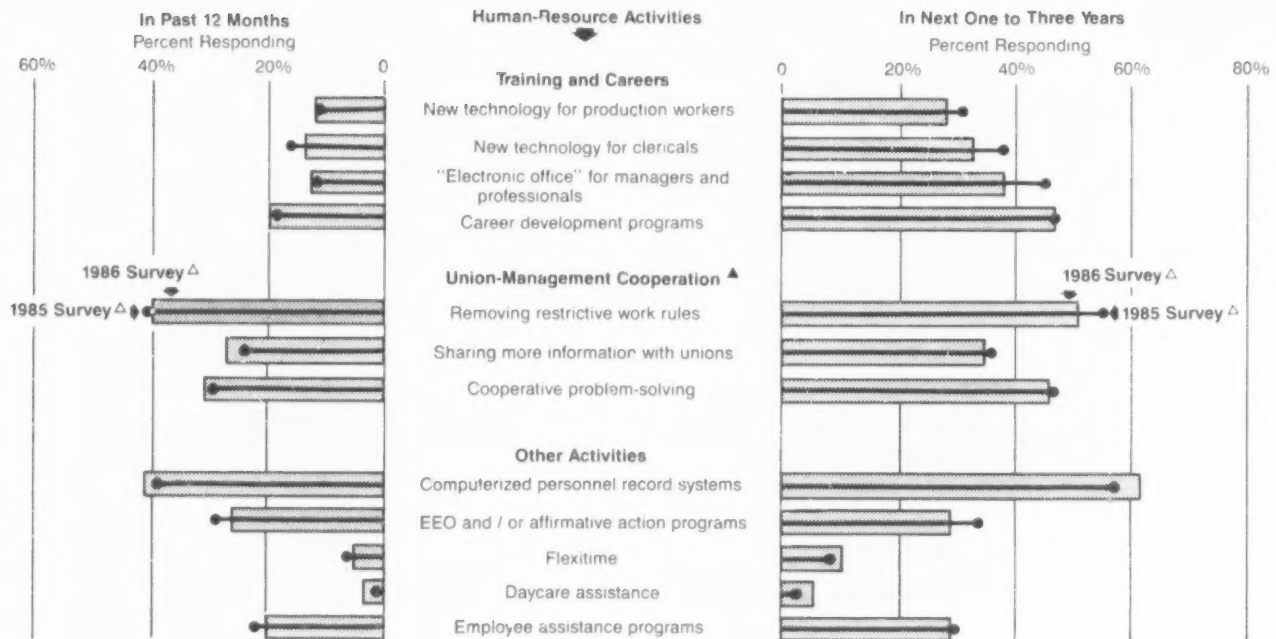


* Multiple responses.

Δ The 1985 survey (N = 486) was administered in May, 1984. The 1986 survey (N = 583) was administered in May, 1985.

(continued)

Chart 4. (continued)
Percent of Respondents Placing
Major Emphasis on Activity*



* Multiple responses.

△ The 1985 survey (N = 496) was administered in May, 1984. The 1986 survey (N = 583) was administered in May, 1985.

▲ Base is the number of companies with union representation.

ecutives in the near term. For example, health-care cost containment programs, the principal activity cited by respondents, are a direct response to the single most important human-resource concern—control of employee-benefits costs. The significance of productivity-improvement programs is consistent not only with the high standing of productivity as an issue, but also with the expectation by 70 percent of respondents that productivity will increase primarily through superior use of human resources. (See Table 5.)

Other key activities identified in Table 7 are less oriented to issues. The computerization of personnel records promises to be a major ongoing activity, but the governing issue—new office technology—has a very low ranking. Three activities of great importance involve the interface between merit pay and performance, managerial performance appraisal, and top-management incentives. Yet the issues embracing these activities are ranked well below concerns with benefits, productivity and planning.

To the extent that issues represent continuing problems and challenges, certain activities may no longer be problematical: Their importance has to do more with implementation than with acceptance. This may be the case with the computerization of records. Since a majority of respondents expect an increase in the introduction of new office technology, particularly into the administration function, the issue of computerization

seems no longer debatable. Similarly, programs to appraise managers and for better remuneration of senior managers may require improvement and expansion, but are no longer viewed as critical challenges per se. Also, as noted earlier, some of the concern with specific compensation and performance issues may be subsumed under such broader issues as productivity improvement and culture change.

Identical lists of human-resource programs and activities were used in the 1985 and 1986 surveys. Chart 4 shows the major emphases reported for the two years. Two general patterns emerge. One is consistency: The assignment of major emphasis to an activity in the 12 months prior to May, 1985, is very close to that reported in the 12 months prior to May, 1984. The same observation applies in comparing the outlook for the near term (next one to three years) in the two surveys. This suggests relatively little volatility in human-resource affairs.

Two exceptions to the above pattern should be noted. Although health-care cost containment is the ranking activity in the near future in both surveys, the proportion of 1986 executives reporting major emphasis (74 percent) has declined noticeably from the 1985 level (82 percent). The degree of major emphasis placed on comparable-worth activities has also fallen from 27 percent in 1985 to 16 percent in 1986. The data are too limited to ascertain whether these differences are trends toward greater health-cost control or toward a deemphasis of the

Table 7: Principal Human-Resource Activities in the Next One to Three Years, 1986

Activities (multiple responses)	Expectation of Major Emphasis	
	Number of Responses	Percent of Respondents (N = 583)
Health-care cost containment programs	430	74
Improving the link between merit pay and performance	410	70
Performance appraisal for managers	402	69
Integrating human-resource planning and corporate business planning	400	69
Computerized personnel record systems	360	62
Productivity improvement programs	355	61
Bonus plans for top management	297	51

comparable-worth issue. Comparable worth may be a moderately important concern, but, pending further legal developments, companies may not know what direction to take.

The second pattern apparent in Chart 4 is the intention to give more emphasis to activities in the near term than in the recent past. In both surveys, greater emphasis in the future than in the past is found for most activities. Several factors may explain this trend. An executive may plan to devote more serious attention to several key programs, but the pressure on the executive's time may upend these goals. Also, executives may simply decide that some programs cannot be handled effectively at present, but require several years' work.

Improving the link between merit pay and performance is a case in point. In 1985, 43 percent of respondents indicated a major concentration on such a linkage in the prior year—compared with fully 70 percent who expected a similar emphasis in the near future. Precisely the same disparity appears in 1986: This activity is undoubtedly important, but it may not be realistic for executives to invest the time they think it deserves.

Attention should be drawn, nonetheless, to *very large* differences between *recent past* and *near term*. Activities judged to be substantially more important in the future than in the past in both survey years may well indicate areas in which human-resource managers continue to experience the greatest urgency. Such activities, in addition to merit pay-performance, are:

- integration of human resources with business planning
- productivity-improvement programs
- career development
- flexible benefits plans
- preparing managers for the "electronic office."

For each of these activities, in both surveys, the proportion assigning major emphasis in the future is at least 20 percent higher than rating it so for the past 12 months.

The list of 39 activities and programs is organized into several subject areas in Chart 4. The human-resource outlook for the next one to three years becomes clearer when the distribution of major emphasis is examined within each area. In benefits and cost containment, the overriding preoccupation will be on controlling health-care costs. Comparatively, much less emphasis will be placed on controlling costs through pension-plan

modifications. More major emphasis will be accorded to cost control in other benefits and to flexible benefits plans.

In productivity and planning activities, quality-of-work-life programs will command comparatively little attention. In the performance area, the merit pay-performance link and managerial performance appraisal will be the dominant activities. Relatively little emphasis will be accorded to comparable pay for comparable work. Bonus plans for top and middle managers will be the significant incentive programs.

On the whole, post-recession retrenchment activities continue to slow down, and rebuilding appears cautious except for hiring in the exempt area. Slightly over 40 percent of respondents anticipate giving major emphasis to hiring managers and professionals. The leading activity in training, education and development programs will be career development, on which nearly half of respondents will place major emphasis.²

Several items on union-management cooperation are shown on Chart 4. Roughly half of respondents expect to devote major emphasis to working with unions in removing restrictive work rules and in cooperative problem solving. About a third expect a serious effort to share more information with the unions. It appears that most of this activity will occur outside of formal labor-management participation agreements since fewer than three percent of respondents with unions view such arrangements as a leading concern (Chart 1).³

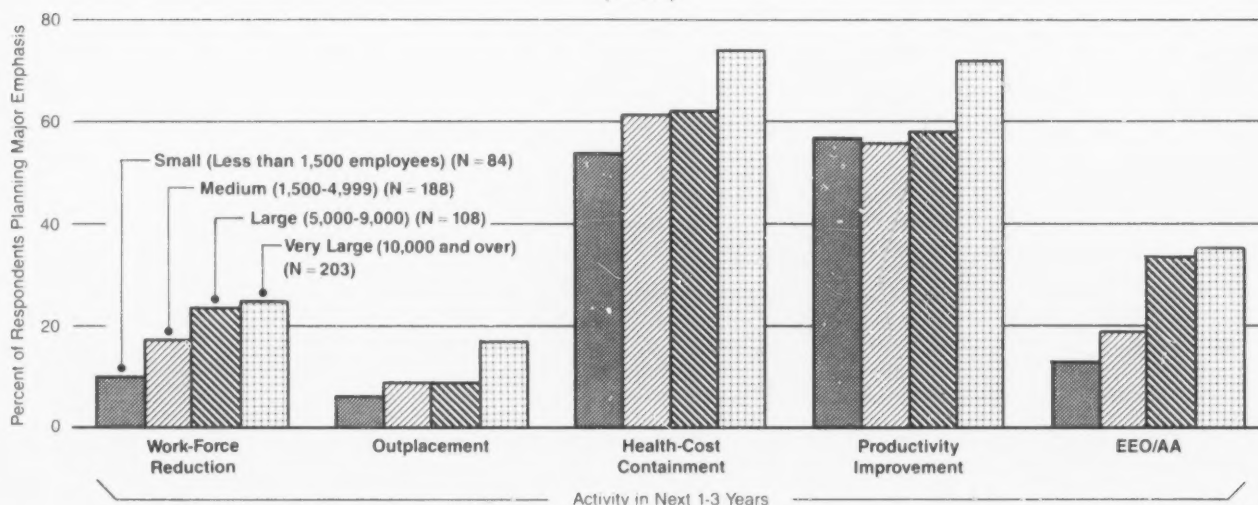
Company Size, Industry Type and Unionization

Charts 5, 6 and 7 show significant differences among respondents to the 1986 survey in the extent to which they expect to place major emphasis on activities in the next one to three years. Differences in company size are strongly associated with differences in emphasis on five of the thirty nine specific programs (Chart 5). The relationship between size and work force reduction, outplacement, health cost containment, and EEO or affirmative action activities is direct—the proportion of

²For a discussion of current development efforts in U.S. companies, see Seymour Lusterman, *Trends in Corporate Education and Training*, The Conference Board, Report No. 870, 1985.

³A further discussion of labor-management cooperation appears in Ronald E. Berenbeim, *Company Programs to Ease the Impact of Shutdowns*, The Conference Board, Report No. 878, 1986.

Chart 5.
Differences in Expected Activity, by Company Size, 1986
(N = 583)



respondents intending major emphasis on the activity increases with the number of employees. More serious attention will be paid to productivity improvement in the very large companies than in firms with fewer than 10,000 employees.

The data suggest that retrenchment activities, to the extent that post-recession effects continue, will be more evident in the larger companies. At the same time, it is in the very largest firms that significantly greater emphasis will be directed to the leading near-term issues: employee-benefits' costs and productivity improvement. The proportion of respondents involved is appreciable. Nearly three-fourths of managers in very large firms plan this high level of commitment to health costs and productivity.

Among the several industry types, durable goods executives intend to devote significantly greater attention to productivity improvement, quality-of-work-life efforts, gainsharing plans and training in new technology for production workers (Chart 6). Financial services executives will place greater emphasis than other executives on flexible benefits, bonus plans for both middle managers and professionals and the hiring of managers, professionals and part-timers.

Chart 6 also shows that appreciable proportions of companies plan to be involved in some of the activities. For example, three-fourths of durable goods respondents will give major emphasis to increasing productivity levels. Over 60 percent of financial services executives plan to hire managers or professionals in the next few years. Further, over half of financial services executives intend to devote major attention to middle management bonus plans.

A number of direct relationships between extent of unionization and emphasis on activity are shown in Chart 7. Emphasis on job analysis and evaluation, bonus plans for professionals, and hiring of managers and professionals decreases with unionization. Work-force reduction and cooperation with

management over the removal of restrictive work rules increases with unionization. Retrenchment activities will be experienced to the greatest extent in the most heavily unionized firms. In general, there is more concern with long-term incentives and job performance in nonunion than in unionized firms. Joint labor-management efforts to loosen or remove work rules will be a prominent activity in heavily unionized firms. The hiring of managerial and professional staff will be a major activity in nonunion companies. These variations in activity reflect differential priorities for human-resource staffs in nonunion and unionized companies in the near term, and, quite possibly, in the longer run as well.

Human-Resource Staff Levels

Data on the number of full-time human-resource professionals were obtained in the 1986 survey for two purposes. The first was to determine whether any changes have occurred, or are expected to occur, in the recent or projected supply of human-resource "person-power." The second purpose was to discover:

(1) if differences in human-resource staffing ratios (the number of human-resource professionals per 1,000 employees) are associated with differences in the perception of major issues, expected changes in business operations, and activities planned for the near term.

(2) if differences in staffing ratios are related to differences in such factors as company size, industry type, and unionization.

Changes in "Person Power"

Respondents were asked to report the number of U.S.-based full-time human-resource professionals currently (May, 1985) in their companies and the number one-year prior to the sur-

Chart 6

Differences in Expected Activity, by Industry Type, 1986

(N = 472)

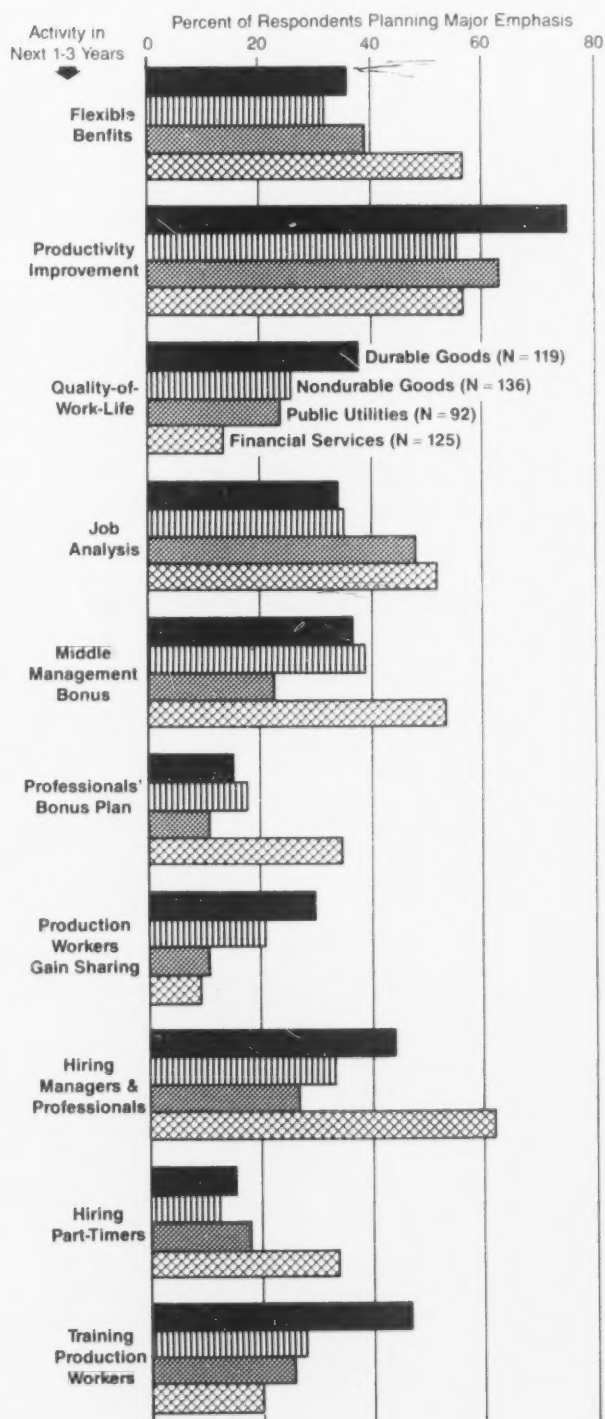


Chart 7

Differences in Expected Activity, by Unionization, 1986

(N = 575)

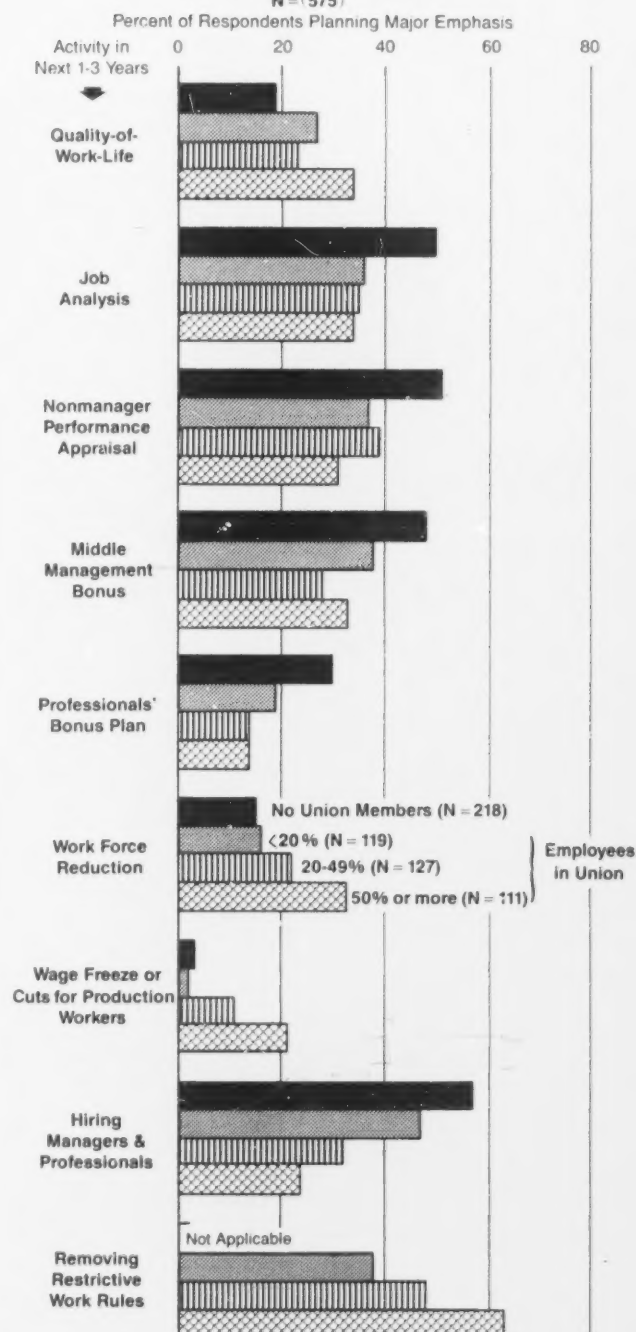
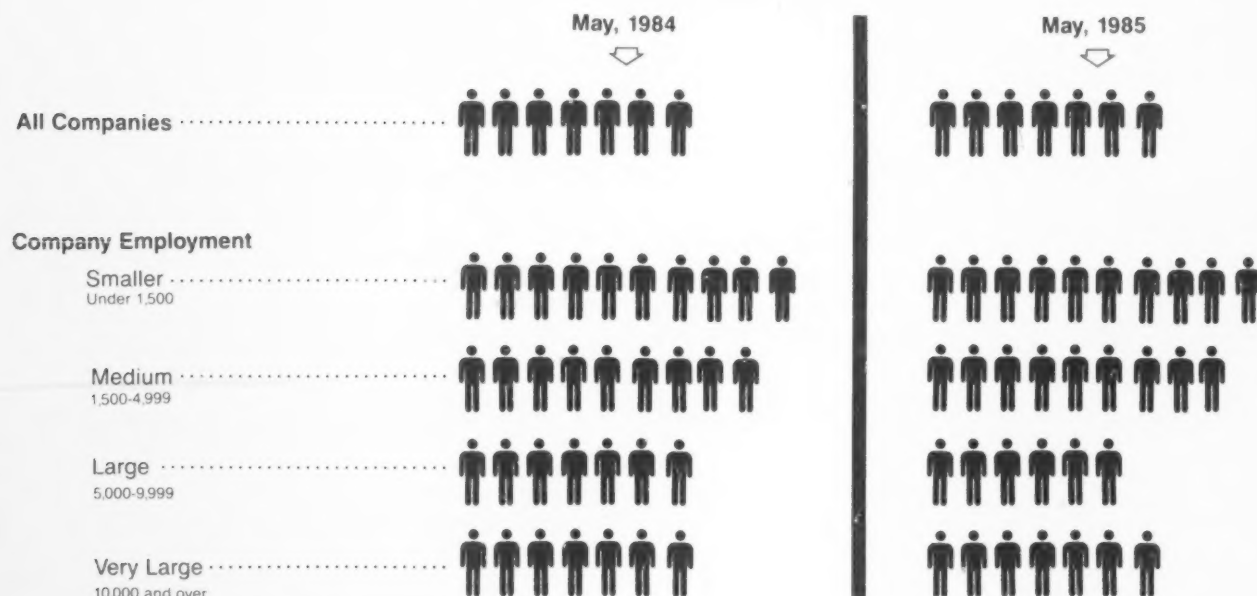


Chart 8.
Human-Resource Staffing Ratio by Company Size
(Number of Full-Time Human-Resource Professionals per 1,000 Employees)



= One Human-Resource Professional



vey. In addition, an estimate was sought for the year ahead. Respondents were also requested to provide the number of their U.S. employees—both currently and a year ago—so that the appropriate ratios could be computed.

Decline in human-resource “person power” does not appear to be an issue for the immediate future. The numbers suggest that any major impact of the 1981-1982 recession had ended, at least by the Spring of 1984. There are two types of supportive data. The first set consists of the median number of human-resource professionals. As the figures below indicate, the medians are stable in the companies in the sample for the three periods.

	Median HR Professionals
May, 1984	36
May, 1985	35
(Estimated) May, 1986	36

The second set of data consists of the ratios of full-time human-resource professionals to the number of U.S.-based employees. These staffing ratios (the numbers of professionals per 1,000 employees) are shown for 1984 and 1985 by company size in Chart 8, and indicate virtually no change.

Issues, Operations and Activities

To examine the effects of different staffing ratios, companies were divided into three ratio groups: fewer than five profes-

sionals per 1,000 employees, five to nine professionals, and 10 or more professionals. Differences in staffing ratios are unrelated to differences in the selection of top issues or in expectations of operational changes as a result of business, economic and social developments. The few activities in which the staffing ratio makes a difference are shown in Chart 9. Increasing staffing ratios are significantly associated with an increasing major emphasis on flexible benefits plans, improving the merit pay link with performance, and hiring managers and professionals in the next one to three years.

Company Size, Industry Type and Unionization

As Chart 8 indicates, smaller and medium-sized companies tend to have higher staffing ratios than large and very large companies. One factor in this difference may be that larger firms, in their efforts to achieve economies of scale, have been able to reduce their human-resource staffing levels over time, possibly by the use of such efficient techniques as computerized personnel records.

Staffing ratios are strongly related to industry type (Table 8) and to unionization (Table 9). Staffing ratios are much higher in financial services firms than in the other industries. Nearly half of financial services respondents are in companies with 10 or more professionals per 1,000 employees. Nonunion companies tend to have higher staffing ratios—over 40 percent report 10 or more human-resource professionals per 1,000 employees. The human-resource staffing ratio tends to diminish with increasing unionization.

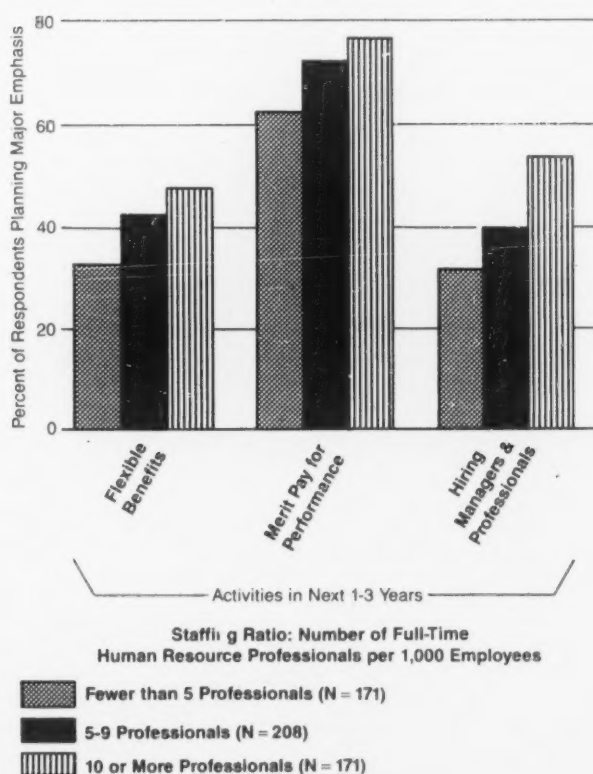
Table 8: Differences in Human Resource Staffing Ratios, by Industry Type, 1986

Staffing Ratio (Number of Full-Time HR Professional per 1,000 Employees)	Industry Type			
	Durable Goods (N = 111)	Nondurable Goods (N = 121)	Public Utilities (N = 89)	Financial Services (N = 122)
	100%	100%	100%	100%
Fewer than 5 professionals	34	33	29	17
5-9 professionals	42	44	37	38
10 or more professionals	24	23	34	45

Table 9: Differences in Human-Resource Staffing Ratios, by Unionization, 1986

Staffing Ratio (Number of Full-Time HR Professionals per 1,000 Employees)	Unionization			
	Percent of Employees in Union			
	Nonunion (N = 204) 100%	-20% (N = 114) 100%	20%-49% (N = 121) 100%	50% + (N = 107) 100%
Fewer than 5 professionals	20	34	31	46
5-9 professionals	38	37	46	31
10 or more professionals	42	29	23	23

Chart 9
Differences in Expected Activity by
Human Resource Staffing Ratio, 1986
(N = 550)



The Changing Human-Resource Function and Issues, Operations and Activities

As noted earlier, respondents identify two major directions of change in the human-resource function. Of those indicating the direction, 69 percent mention movement toward strategic concerns and 31 percent cite operational changes. (See page 6 above.)

Perception of the changing function does not distinguish among executives' designation of leading issues. In the area of business operations and results, the following trends appear:

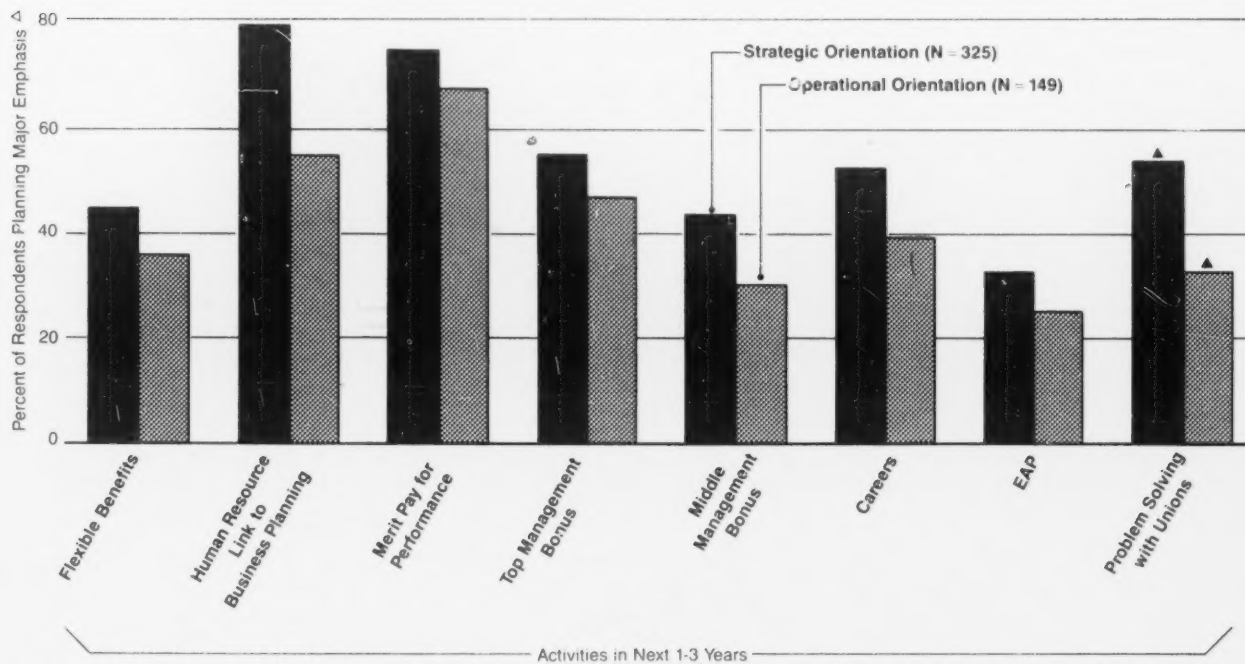
Expected Change	Percent in:	
	Strategic Direction	Operational Direction
Increased scope of operations outside the United States	25	13
Productivity change due to:		
Application of new technology	65	55
Quality-control procedures	33	21

Executives who differ in their basic approach to the question on the changing human-resource function are consistent in their feelings about the near-term importance of strategic human-resource planning as an activity. As illustrated in Chart 10, nearly 80 percent of strategically oriented managers plan to devote major attention to the human-resources link with bus-

Chart 10.

Differences in Expected Activity by Perception of the Human-Resource Function, 1986

(N = 474)



^a Base excludes respondents giving no answer.

^b Base is the number of companies with union members.

iness planning, as against 55 percent of the operationally oriented.

Other differences in anticipated activity emphasis of these two groups are also shown in Chart 10. Strategically oriented executives will place significantly more emphasis on flexible benefits, pay for performance, bonuses for top and middle management, career development, employee-assistance pro-

grams, and problem solving with unions than will their operationally oriented counterparts.

Perception of the changing human-resource function is related to company size, as noted earlier, but not to industry type or unionization. Strategic orientation and operational orientation are not associated with differences in human-resource staffing ratios.

Forecasting Public Affairs Priorities

by Catherine Morrison

Management Summary

How Do Companies Rank Issues?

The ten most important issues are:

- | | |
|--|---------------------------------|
| 1. The federal budget and related tax reform | 6. Health-care cost containment |
| 2. Regulatory reform | 7. Economic concentration |
| 3. Environmental protection | 8. Local issues |
| 4. Energy development | 9. South African investment |
| 5. International trade relations | 10. Plant closing laws |

Company Commentary on Key Issues

Officers comment on the single issue of most pressing concern to their organizations. Included (with the above) are tort liability, regulations affecting telecommunications, transit, banking and financial services.

Single-issue lobbying is the method of choice for three-quarters of the firms.

Respondents distinguish between systemic or process failures, and unsuccessful intervention.

Forecasting Emerging Public Policy Issues

Companies are virtually certain that in 1987 they will still be dealing with tax reform, deregulation, the federal budget deficit, environmental protection, international trade, and health-care costs.

Corporate Relations Program

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Introduction

Corporations are justifiably concerned about changes in the social and political environment which, through legislative, social or economic action, can affect the ways in which firms are permitted—or required—to do business. Many of these changes are described as *public policy issues*, since most of them are in the public domain and involve public opinion and matters of national policy.

Most public policy issues of concern to business have certain shared elements. First, while a minority may be of importance primarily within a state or region, most have national implications. And even those that affect only a single state or region most often have the potential for affecting business operations in other than the immediate location. Second, the issue is likely to generate legislation (as new statutes or as amendments or revisions of existing laws). Most important, should this legislation be enacted, it will certainly impinge on, or directly affect, business operations.

Thus, it is obvious that business would like to be aware of potential changes in public policy as early as possible. To do this they must be able to identify and track issues as they develop.

The Corporate Tracking Effort

Corporations invest millions of dollars every year in the process of identifying and tracking issues. This intelligence-gathering process is justified on numerous grounds. First, corporate managements abhor uncertainty because it renders long-range planning impossible. Most issues are seen as inexorably linked to change and, in order to prepare for change, corporations must have some idea of the dimensions of the related organizational, financial and managerial adjustments. An early warning on either changing public attitudes or the emergence of a concern new to both the public and to lawmakers, is viewed as having critical importance.

Firms also want to be able to participate in the legislative process that usually accompanies the development of an issue. This Conference Board survey focuses not only on which issues are of concern to companies but also on the firms' reactions, that is, their mode of preparation and level of involvement. In large measure, public affairs officers say their companies' stances are still reactive rather than pro-active. One public affairs executive says: "We are often more likely to become engaged in the process of [reacting to and] shaping the issue by our lobbying efforts during the national debate than we are likely to act on an early identification."

About This Report

In order to assess how corporate officers define, rank and manage various public policy issues facing their organizations, The Conference Board conducted a mail survey and field interviews during the Spring and Summer of 1985. A list of 950 public affairs officers was selected, drawing from the 1,000 largest industrial firms, and the 250 largest service companies (finance, transportation, insurance, and so forth). Questionnaires were mailed to these companies and 252 usable responses were obtained. Approximately three quarters of the respondent companies were manufacturing firms and the remainder were service firms from the financial, transport and business services sectors. The data from these questionnaires constitute the principal source of information for this report. Personal and telephone interviews were conducted with public affairs officers, government officials, and functional executives in human resources, legal and financial departments of the respondent companies, in order to gain additional insights on issues affecting these units' operations.

Because of the volatile nature of some issues, and the ongoing legislative activities that alter the status of various issues (e.g., tax reform, budget deficit), this analysis represents a snapshot of corporate concern at a particular point in time. It is the intention of The Conference Board to repeat this study at regular intervals with this initial report serving as a baseline against which we will measure shifting company attitudes and priorities. The survey was conducted in response to inquiries from CEO's, public affairs officers, and other senior executives seeking to obtain comparative data on how competitors and other companies of similar size and organization rate various public policy issues, and the extent to which these other firms may be involved in the public debate. Because this report measures both the rank ordering of the issues (in terms of their importance to the corporations), as well as the degree and type of corporate involvement in them, it should provide a useful response to these inquiries.

How Companies Rate Their Early Warning Abilities

The vast majority of companies do not believe that they are caught unawares by emerging public policy issues. A fifth rate their early warning systems as "excellent"; only 3 percent of all respondents believe that their companies do a poor job. (See Table 1.) "Despite the myths about corporations being insensitive to developing issues, nobody or no issue is really sneaking up on us," the public affairs manager for one consumer goods company says.

Organizing the Tracking Effort

A slight majority, 53 percent, report that they do *not* use a "formal" issues-tracking effort. In other words, they do not

Table 1: Companies' Evaluation of Their Ability to Identify Key Public Policy Issues

<i>Evaluation Rating</i>	<i>Percent of Companies (N = 252)</i>
Excellent	21.0%
Good	45.0
Average	31.0
Poor	3.0
	100%

have a formal plan or a budget for tracking issues. Instead, these companies rely on the overall sensitivity of their staff members to issues of concern to the company. While they may subscribe to consultants' polling and tracking services, they do not consider this a "formal" effort.

By contrast, the minority of responding companies—usually those with larger public affairs staffs—have designated one or more individuals to be wholly concerned with the firm's public policy agenda. This individual or group manages the issues identification and tracking program, which usually has an established budget and an agenda of issues priorities.

Regardless of whether or not a firm uses a formal tracking effort, nine out of ten rely on internal staff for identification and tracking activities. Firms may augment corporate staff through the use of consultants, sponsored polls and surveys, and related activities, but the overwhelming majority rely primarily on internal resources.

The firms that do use outside suppliers say that they do so in order to gain objectivity, reduce staffing costs, and obtain the advantages of the shared costs of multiclient surveys and studies. The principal disadvantage to the use of outsiders, public affairs officers say, are problems of timeliness and the questionable value of an outsider's perception of how an issue will actually affect the firm's operations. "Outsiders tend to produce generic research," one public affairs executive points out. "Those data are all right for a starting point, but we still need to do a lot of staff work of our own in order to see how an issue is going to have an impact on our company."

Briefing Top Management

Some public affairs officers prepare a formal issues agenda for their top managements' attention. This is usually a briefing that offers an agenda of issues and contains a short description of the evolution and current status of each, as well as its implications for the company. However, almost two-thirds (63 percent) of the companies studied do not use a formal issues agenda. Instead, they rely on reports issued at irregular time intervals, that focus on the top issues of concern to the company. In essence, this is a form of "management-by-exception" reporting. Reports are only directed to top management when the issue reaches a critical stage requiring company involvement in, for example, a government relations activity.

National versus Local Concerns

As Table 2 illustrates, national and state issues receive the greatest attention from the firms surveyed. Over half picked national issues as being of first importance, but nearly a third said that, for their firms, state issues rank first.

As might be expected, differences in corporate size, product or process, and markets served influence a company's allocation of resources among national, regional and state issues. Not surprisingly, multinational companies tend to rank international issues much higher than firms whose products are intended primarily for domestic markets. And, highly regulated industries—with the exception of banks and insurers that tend to be regulated on a state-by-state basis—rank national issues of much greater concern than they do state issues. In general, consumer goods firms rank national issues of greater concern than do industrial companies.

Levels of Corporate Involvement

For the purposes of this study, it was assumed the level of involvement of company staff and resources defines a corporation's concern with an issue. On issues of primary concern to the company, where the level of interest is reflected either by active lobbying, the support of advocacy groups that espouse the corporation's position, or the assignment of company staff and resources to a particular issue, companies are

Table 2: Rating of Issues by Importance—Geopolitical Boundaries

<i>Geopolitical Issues Category</i>	<i>Percent of Firms' Ranking</i>				
	<i>1st¹</i>	<i>2nd¹</i>	<i>3rd¹</i>	<i>4th¹</i>	<i>5th¹</i>
National Issues	53	21	11	15	—
State Issues	33	41	20	6	—
Local Issues	9	14	30	28	20
Regional Issues	2	10	27	35	25
International Issues	6	15	15	14	51

¹Details do not add to 100 percent because of rounding.

Table 3: Levels of Corporate Involvement in Public Policy Issues

<i>Title of Issue</i>	<i>Percent of Firms Actively Involved</i>	<i>Percent of Firms Closely Monitoring</i>	<i>Percent of Firms Reporting General Interest</i>
Federal budget deficit or tax reform	50.6	23.0	25.1
Environmental protection	46.9	24.3	20.2
Regulatory reform	41.6	25.5	30.0
Health-care costs	41.2	37.0	18.1
International trade	35.8	21.8	27.2
Reregulation	31.5	31.1	29.5
Local community issues	29.5	23.7	35.3
Business and education	21.0	19.8	45.7
Electoral reform	20.2	43.2	29.2
Financial disclosure	19.8	42.8	30.5
Plant closing laws	19.8	33.7	29.2
Comparable worth	15.2	50.6	30.0
Age discrimination	14.8	53.5	29.2
Economic concentration	14.8	43.2	37.0
International investment	14.0	24.0	32.2
South Africa investment	12.5	13.8	19.2
Discrimination against handicapped	12.4	36.8	46.3
Ethnic discrimination	10.7	48.8	36.8
Family services	7.9	25.7	54.8
Structural unemployment	7.9	16.7	55.8
Employment-at-will	7.8	41.2	41.2
Federal Reserve issues	6.2	26.9	53.3
Third World issues	4.6	13.3	19.9
Religion and business	4.1	15.6	36.2
Immigration reform	2.9	10.3	34.2
Aid to Israel	0.8	4.6	20.7
Disarmament negotiations	0.8	2.5	23.9

described as being "actively involved." (See Table 3.) These issues tend to be those thought likely to involve legislation which would—or could—impede a company's manufacturing or marketing operations. In a few cases, such as tax reform, or budget-deficit financing, an issue may so significantly affect the overall economic climate that a company will inevitably expect an impact.

In other instances, companies keep a wary and watchful eye on the development of an issue—without any actual "involvement." In these cases, they have not yet committed themselves to a lobbying effort, or attempted to affect public debate by advertisements, public pronouncements, or support of advocacy groups. However, they are closely watching the issue through the use of company staff and resources to track and report on developments. These companies are said to be in a stage of "close monitoring."

Finally, companies may just have an "intellectual interest" in the issue because of its general impact on the nation's economic and social system. These firms will expend no special effort to collect information on this category of issue, but neither will they ignore reading about it or keeping generally informed on its development. Finally, as might be expected, there are some issues of so little direct concern to the company that firms say that they pay no attention at all to such matters.

How Companies Rank Issues

In order to provide a shopping list of issues that companies could choose from—in terms of both ranking and reporting on their degree of concern and involvement—Conference Board researchers first conducted a series of interviews with public affairs officers to determine which issues were of most concern to these executives. Researchers also reviewed secondary sources, such as public opinion polls, industry surveys, and so on, to uncover additional issue topics. In total, twenty-six separate issues were identified. (See box inset page 7.)

The Ten Most Important Issues

The companies surveyed were asked to rank the top ten most important issues affecting their firms, from among the twenty-six issues available. Some added issues, and these were included in the tabulation. The survey respondents chose, as the most important issues, the following ten categories, in order of their importance.

1. The federal budget deficit and related tax reform
2. Regulatory reform
3. Environmental protection
4. Energy development

5. International trade relations
6. Health-care cost containment
7. Economic concentration
8. Local issues
9. South African investment
10. Plant closing laws.

Nearly a quarter of all firms rank the federal budget deficit as the leading policy issue of concern to their companies. Respondents use terms such as "out of control" and "fiscal morass" to describe the current budget situation. Many point to a link between federal budget deficits and to what they see as the overvaluation of the U.S. dollar, with a resulting impact on the trade deficit and related difficulties in securing international markets for U.S. exports. Just over half of the companies surveyed report an active involvement with this issue through corporate lobbyists or trade associations; nearly another quarter are closely monitoring this issue.

Company Comment on Key Issues

Company spokesmen were asked to describe the single issue of most pressing concern to their company and to elaborate on the reasons for that concern. An analysis of the commentary indicates that the following areas, listed by frequency of mention, received the most comment.

1. The federal budget deficit and related tax reform
2. International trade relations
3. Energy regulation
4. Toxic waste and Superfund
5. Telecommunications regulations
6. Banking and financial service regulations
7. Health-care costs
8. Tort liability reform
9. Transit regulations
10. Miscellaneous issues, such as South Africa, comparable worth, and general commentary regarding regulation.

The Federal Budget Deficit, Related Tax Reform

Current moves in the Congress to alter radically the rules by which the U.S. tax game is played are a subject of deep concern for many companies and industries. Insurers, banks, energy producers, and others are particularly worried that changes in tax structure will either dramatically increase their tax liability or significantly alter the ways in which their firms can do business.

Typical comments from such firms follow:

• "We do not oppose reform, simplification, and so on. However, we are very concerned that incentives for productive capital investment may be thrown out in the name of reform. We must stop the deindustrialization of the United States."

—an electrical machinery producer

• "Tax reform is of prime concern to us, particularly the

need for enhanced equity among corporate tax payers, resulting from the growing disparity of effective tax rates among industries."

—a multinational food producer

• "Tax reform is by far the most important policy issue affecting the present and future of our corporation. First, it affects corporate policy in earnings. Second, it determines our ability to raise new capital for investment purposes. Third, it has an impact on oil and gas production, critical to our nation's defense, economic structure, and energy independence. Fourth, broad changes in a finely tuned tax structure can potentially have a very negative impact on our investors."

—an energy producing firm

• "Tax issues and their relationship to research and development are very important to us and to the nation, if we are to remain competitive."

—an electronics company

• "Taxation at federal, state and local levels has a great impact due to our large land and property holdings. Property, income and sales taxes are major priority issues for our firm's staff."

—a building products supplier

• "Federal tax reform is critical to our company. With an average effective tax rate of over 40 percent, we are particularly interested in efforts to reduce corporate tax rates. A reduction to 33 percent, as proposed by the Reagan Administration, would result in annual tax savings of more than \$10 million for our company."

—a food retailer

Of particular interest in tax-reform proposals is the taxation of various employee benefits, such as insurance and health care, which are not presently subject to taxation. This proposal, as might be expected, is of particular concern to many of those in the insurance and financial services sector. Sample comments include:

• "Proposed taxation of employee benefits and life insurance cost values would be a disaster to our clients and to the public in general. Proposed taxation of fringe benefits, and the proposed taxation of inside build-up [dollar appreciation] of life insurance policies, will, if adopted, seriously damage this company's ability to survive."

—a life insurance company

• "Pending tax reform proposals that would produce an unfair and unsound tax on employee benefits, as well as a tax on the inside build-up of cash value on life insurance and annuities, would undermine the financial security and health protection of millions of Americans. It would also generate increased burdens on government via a "national health plan," and jeopardize the insurance industry that provides this protection."

—a health care insurer

• "Taxation of inside build-up on investment-type insur-

Issue Descriptions

***Aid to Israel.** Implication of extended aid to firms with buy-back responsibilities and those doing business in the Middle East.

***Business and Education.** Increased support to institutions; participation in the performance and structural aspects of the education system.

***Disarmament Negotiations.** The efforts and strategies to gain mutual arms reduction.

***Discrimination:**

- Age: issues involved in promotion, forced retirement, and new employment;
- Comparable worth: the continued examination in state courts and legislatures of the idea that men and women should receive the same pay for doing different jobs of similar difficulty that require equivalent skills;
- Ethnic discrimination: discrimination by color or nationality;
- Discrimination against the handicapped: training and provision of facilities to encourage employment of the handicapped.

***Economic Concentration.** Antitrust issues; methods of financing mergers; economies of scale; managerial efficiencies, etc.

***Electoral Reform.** Pending reforms; the role of PACs.

***Employment-at-Will.** The doctrine of implied employment contracts and the increase in court cases alleging wrongful discharges.

***Environmental Protection.** Responsibilities of companies in the balanced management and development of natural resources.

***Family Services.** Provision of day-care assistance, flex time programs, part-time work with prorated benefits, maternity leave as a disability, counseling for spouses and dependents.

***Federal Budget.** Reducing the deficit; related tax and budgetary reform.

***Federal Reserve Issues.** The effect of monetary policy on in-

terest rates; oversight; lobbying to limit the powers of the Federal Reserve Bank.

***Financial Disclosure.** The release of company finances and operating results to the public, stock analysts, the media, etc.

***Health-care Costs.** Regulations to help contain costs by limiting doctors' fees, hospital growth, delivery system efficiencies, the related role of companies.

***Immigration Reform.** Proposed employee identification; employer liability for the hiring of aliens.

***International Investments.** Issues of joint ownership; technology transfer; expropriation; repatriation of assets; protection of facilities and employees against terrorist attacks.

***International Trade Issues.** Competition from foreign imports; subsidies; loan guarantees; the rise of the dollar.

***Local Community Issues.** For example, housing, zoning, industrial development, crime, etc.

***Plant Closing Laws.** Notice regarding the closure of plants, the anticipated strictures on location of new facilities, and related responsibilities for retraining workers; company-union relations.

***Religion and Business.** The impact on business of organized religious groups' advocacy of their interests.

***Regulatory Reform.** Further changes in regulations affecting business operations.

***Reregulation.** Reimposition of regulations in selected business sectors.

***South Africa.** The level of activity in responding to the boycotts and other current tensions.

***Structural Unemployment.** Retraining workers and redirecting students' career choices relative to long-term changes in labor pool requirements.

***Third World Issues.** The extent of concern regarding safety and public health issues in Third World countries.

ance policies could result in sweeping changes in the way the industry is structured. State-mandated health benefits and insurance coverage encourages employers to opt for uninsured and unsecured health programs and produces serious losses to insurance companies."

—a health and casualty insurer

International Trade Relations

As other recent Conference Board studies have shown, U.S. firms are increasingly restive over what they regard as unfair foreign competition! A variety of firms, representing a diverse cross-section of industry and product types, commented on this issue. These observations include the following:

- "As a major producer in the U.S. textile industry, we are deeply concerned about the growing imbalance of international trade and the impact of unfair and unrestrained imports of foreign textile products flooding U.S. markets. At the same time, these countries close their markets to U.S. textile

products; the result is a loss of U.S. jobs and the eventual capture of key U.S. markets by foreign producers."

—a textile manufacturer

- "There is a need for a national industrial strategy—not a policy—to attack the negative balance of trade and the coming credit crunch. U.S. businesses must be allowed to successfully compete with international competitors for a fair market share. The U.S. government should assist and not impede this process."

—an industrial equipment producer

At the same time, spokesmen from a minority of firms were worried that the swing toward protectionism—regardless of the arguments offered by its opponents—would ultimately have an adverse effect on the U.S. economy. Typical of these comments is the following:

- "Trade protectionism and undue restrictions on imports can adversely affect the U.S. marketplace. We seek domestic suppliers as a normal efficient business practice. But foreign suppliers are also sought for new, unavailable products of high quality and lower cost. Restricting trade only reduces competition and harms the consumer."

—a drug retailing firm

¹For example, see Seymour Lusterman, *Foreign Competition and U.S. Trade Policies*. The Conference Board, Research Bulletin Number 187, 1985.

Energy Regulations

A number of firms participating in the survey are intimately involved in energy issues, either as producers or major consumers of energy. Most of these cite issues concerned with energy use, and/or regulation as their primary concern. Among the comments offered are:

- "Development of energy resources is vital to support an expanding economy. This issue is of extreme importance to both this company and the nation."

—a western utility firm

- "Adequate supplies of electrical energy in the 1990's are needed in order to sustain economic growth. Regulations of the nuclear industry frustrate new plant construction; air-quality regulations and acid rain proposals cloud the future of coal-burning plants. We need political decisions that assure that energy can be available at a reasonable cost."

—a southeastern utility

- "Politicized rate decisions are currently of the greatest interest to us. Without clear economic decisions, the company faces a tough financial future as it attempts to recover its investment in a shut-down nuclear plant."

—a midwestern utility

- "Changing competitive pressures at all levels of the natural gas industry are causing a fundamental change in our business. We are increasingly forced to act like any other business in a highly competitive industry, and much less like a regulated monopoly. This is a profound shift that will affect most aspects of our business."

—a western gas producer

- "We are particularly interested in the ongoing transition of the energy industry from a strongly regulated market to a 'freely competitive' market. This is creating dramatic changes in the way we have historically conducted our business. The impact on the methods and sources of future financing requirements is particularly severe."

—a gas transmission company

- "As a refiner, our company is particularly concerned with the increased reliance of the United States on foreign imports. Not only is this a threat to the viability of smaller independent refiners, but also a threat to the security of the nation."

—a midwest petroleum company

Toxic Waste and Superfund

Several environmental issues are of concern to the companies surveyed. None are so pressing as those dealing with Superfund and toxic waste disposal. The comments on this issue include the following:

- "As a long-time chemical manufacturer, we own and operate a number of toxic waste sites. Cleanup standards and criteria are extremely important. The entire matter of joint and several liability is of keen interest in connection with those sites to which we are small contributors. The question of the

method of funding has immediate and direct impact on our international competitiveness and profitability."

—a chemical company

- "Superfund reauthorization is our first priority. Substantial increases in taxes for this would be extremely costly to our company at a time when competition from imported products has reached critical levels."

—a chemical firm

- "Superfund liability, and the lack of affordable liability insurance, exposes our company to considerable economic risks in the marketplace. As distributors, we would not be able to recover from a costly, multimillion-dollar damage suit as well as a manufacturer that enjoys larger profit margins and has more tangible assets."

—a chemical products distributor

Other issues involve concern about the environment in general, or the overall impact of environmental regulation on company operations.

Typical of the comments are:

- "The impact of not weighing risk versus benefit is a disservice to society that extends far beyond electrical utilities. These unwarranted restrictions affect employment by producing a higher cost of electricity and encouraging an already skyrocketing level of electricity imports from Canada."

—a midwestern utility

- "Federal and state environmental policies have a significant impact on our ability to gain access to acreage with resource potential and to locate and operate our facilities."

—a petroleum company

- "We are concerned that the environment (air, water, etc.), be kept clean. However, the regulations that come down are far more strict—and thus too costly—than is required to do a good job."

—a foundry firm

- "Environmental regulation is of intense interest because of the enormous economic impact on our customers and shareholders of unwarranted, unnecessary and punitive legislation."

—a waste management company

- "Environmental laws and regulations are the bane of this company's existence—yet they are the reason for the company's existence."

—a waste management company

Telecommunications Regulations

Perhaps no other industry has been so radically affected by regulation or deregulation as telecommunications. Telephone companies are concerned not only over what has already taken place, but about the direction in which future deregulation might lead. These companies' comments include:

- "Deregulation has rapidly and radically changed the telecommunications business during the last few years. It has

left no part of our business untouched. Managerial, marketing and planning areas have been greatly affected and the changes have only just begun.”

—a California telephone company

- “Future steps by the government relative to competition in telecommunications are a critical issue for our company. Will the regulated carriers be allowed a level playing field on which to compete, or will they be restricted by being saddled with old-style regulations?”

—a western telecommunications company

- “Since deregulation, the cable industry in general, and our company in particular, has had to deal with regulation at every level—locally, through franchise agreements; statewide, through public-utility commissions; and federally, through the FCC and other regulatory agencies. With the passage of the Cable Communications Act of 1984, the burdens of rate-setting [applications] increased for basic services and renewal and franchise fees. Efforts are now underway to position cable as a First Amendment electronic publisher.”

—a national telecommunications company

Banking and Financial Service Regulation

Banks, insurers, stock brokers, and other financial service firms are focusing their attention on the impact that deregulation of their industries has already produced, and are worried about future effects on competition that might result either from further relaxation of regulation or—in some cases—from the reimposition of regulation. Among the concerns voiced by those in the survey are:

- “Deregulation of bank products and services and interstate banking are of major concern to us. Our position calls for a national policy regarding both issues.”

—a midwestern bank

- “Government regulation of the finance industry is quite simply a life and death issue for us.”

—a southeastern bank

- “The efforts of the banking community to enter the life-insurance business—through bank deregulation—will have an enormous impact on the financial services industry and is our primary concern.”

—a northeastern life insurance company

Health-care Costs

A number of firms, including many not in the health-care products or services sector, are vitally concerned about the impact of steadily rising health-care costs. Among the worries they express are:

- “Health-care cost containment directly affects the cash flow and profits of our company’s health insurance operation. And, the taxation of health-care benefits would also, of course, affect the sale of our products. Thus, cost containment is of vital interest to us.”

—a southeastern life insurance company

- “Rising health-care costs are increasingly significant as operating costs to corporations. Many ways to reduce these costs are being explored at our company.”

—a transit company

- “As a life-sciences company, we are naturally concerned with public policies affecting our medical products while, as payers of insurance for our employees, we must consider cost-containment measures: not just for our company, but most broadly. The future of health-care will be a major corporate issue.”

—a medical products supplier

Tort Liability Reform

Both manufacturers and insurers are worried about the rise in tort liability litigation. They are concerned about the cost impacts on companies’ operations and about the availability of insurance protection. Typical of the concerns expressed are:

- “Tort liability rulings in today’s legal climate are costly, and they set widespread precedents that could bankrupt the insurance industry.”

—a midwestern insurance firm

- “The medical malpractice issue is of overwhelming importance. We’re the largest insurer in this line. Many interested parties have offered solutions to the rising claims and costs, but it is a problem that is still with us.”

—a northwestern insurer

- “Tort liability considerations are affecting the way we do business and the kinds of products we introduce.”

—a consumer goods manufacturer

Transit Regulations

Trucking, airline and railway firms have traditionally made regulation an issue of prime importance. In today’s regulatory environment, with all of the uncertainties that a company faces as a result of deregulation—and the prospect for reregulation in certain sectors—transportation firms are particularly concerned with regulatory issues. Among the comments provided are:

- “The ninety-ninth Congress is reexamining the 1980 Staggers Rail Act which partially deregulated the financially troubled rail industry. New or renewed regulation of the free-market environment could have a serious impact on the competition and innovative marketing now prevalent in the industry.”

—a midwestern railroad

- “Congressional efforts to reduce the federal deficit have put funding for passenger service in jeopardy. The significance of this problem is obvious—in terms of both continued operations of passenger lines and employee morale.”

—a northeastern railroad

- “The process of reregulation, then deregulation and reregulation, will cause the demise of many U.S. airlines.”

—a regional airline

• "Regulation and deregulation are at opposite ends of the same spectrum and vital to our company. The free market has brought us into a truly competitive environment. As a result, we have accomplished an economic turnaround and achieved success in the marketplace."

—an international airline

Miscellaneous Issues

Several of the firms surveyed also listed various human resource topics as issues of prime concern to their firms. Comparable worth was listed by some companies that believe that this issue is likely to have great staying power and to become even more important over time. The expansion of employees' protection against arbitrary termination, as expressed in state-based employment-at-will statutes, also worries a number of firms.

Reflecting the international climate, several companies say that the situation in South Africa, and its likely effects on U.S. investments in that country, are also a matter of concern. These companies point out that the South African position on apartheid is rapidly becoming a major domestic public policy issue that will continue to concern U.S. multinational firms for years to come.

Focusing Company Resources

In measuring degrees of company involvement the survey finds that companies are currently most likely to commit resources by active lobbying or support for groups attempting to affect the public on these issues (what we call "active involvement"). It is also possible to combine the "active involvement" category with "close monitoring" to obtain a broader indication of significance. This produces a slightly different rank ordering. When "active involvement" and "close monitoring" are combined, the ten top issues are:

1. Health-care costs
2. Regulatory reform
3. The federal budget deficit and related tax reform
4. Environmental protection
5. Age discrimination
6. Comparable worth
7. Electoral reform
8. Reregulation
9. Economic concentration
10. International trade.

Analyzing Public Affairs Failures

Respondents were asked to comment on instances in which they had been less than successful in their mission to affect the debate on, and resolution of, issues. Answers fell into two main categories; the first concerned systemic or process failures; the second category dealt with specific issues on which company efforts to intervene had been unsuccessful.

The chief systemic difficulties fall into six categories.

- (1) *The "too little, too late" syndrome.* Public affairs ex-

ecutives complain that, in some instances, their firms had been late in reacting to issues of vital concern to the company and that, when the reaction did take place, it was so weak as to be of little value. This does not mean that the company did not identify the issue early. Rather, it suggests that senior management was unwilling to believe that the issue would have a severe impact and that it was too late to make a difference by the time they did accept this notion.

One public affairs executive says: "Typically, we warn management of various legislative initiatives or proposals that will clearly affect our operations. But, sometimes, either they don't believe the law is going to be passed or they just don't want to get involved. Then, at the eleventh hour, they decide to get into the act but usually on a scale that won't make any difference."

(2) *Failure to recognize how long it takes to change attitudes.* Respondents point out that companies often underestimate the length of time it will take to change public attitudes about particular issues. They believe, some public affairs officers state, that by simply exposing the public to the "truth" of a particular situation that attitudes will automatically change—but often they do not. This is particularly true in the case of environmental issues. "We go in with two strikes against us, when it comes to persuading the public that we have no intention of transgressing environmental laws. People seem to believe that companies inherently want to pollute," one executive states.

(3) *Failure to become involved in local issues until confrontation with public interest groups occurs.* Many companies prefer to stay out of local community disputes. As a result, they fail to take a position on issues that ultimately will affect their businesses. In some cases, respondents point out, firms fail to express themselves on an issue until they are confronted by an adversary. Then, the public affairs specialists say, it is too late for the firm to garner local community support for its position.

(4) *Reluctance on the part of both senior- and mid-level managers to take time out of their schedules to become involved in issues management.* Both top- and mid-level managers, the survey respondents report, have an aversion to becoming involved in issues management. They believe that this is a task that can be wholly delegated to a specialist group in the company, that is, public affairs. But statements from top- and mid-level managers explaining company positions on various complex or technical issues are often needed. It is not enough to rely solely on "company spokesmen."

(5) *Failure to communicate the strategies and tactics used by companies in dealing with public policy issues to employees.* When companies do become involved in attempting to alter public opinion or their legislators' views on issues of concern, they sometimes fail to let their own employees in on the company's positions, strategy and communications tactics. Companies sometimes ignore employees and consider them another part of the public at large, a common systemic failure in issues management.

- (6) *Inability to educate legislators to the nature of the com-*

pany's business. In attempting to influence the course of legislative action, companies are often stymied by their inability to "educate legislators" on how these firms do business. In particular, public affairs officers complain that legislators often have a poor grasp of financial concerns. The fault does not lie with the legislators alone; companies do not always make a convincing case when describing the impact that various legislation will have on their financial structures.

Failures on Individual Issues

Some of the respondents surveyed chose to focus on a particular issue that had attracted considerable company attention and effort and yet had resulted in failure. The five issues most frequently described as "failures," in that firms were unable to persuade legislators or regulators of their views, include:

- (1) Tort liability reform
- (2) Federal budget and tax reform
- (3) International trade issues—particularly the use of "voluntary restraint" agreements
- (4) State-level issues, such as unemployment taxes, environmental regulation, and so forth
- (5) Natural gas deregulation.

There were other failures cited, but they usually referred to a specific company situation or a narrow interest. Each of the five topics noted was mentioned by several respondents.

Methods Used to Affect Issues

Companies have a variety of methods available to them by which they can hope to affect the development of public policy issues; methods that may persuade key constituent groups (customers, stockholders, the public at large, etc.), that the company's views on a particular issue are the correct ones. Public affairs officers were asked to indicate which of the seven principal methods (listed below) they use in attempting to influence an issue.

- (1) Single-issue lobbying
- (2) Working through trade associations
- (3) Working with groups of companies
- (4) Supporting those candidates who share company views
- (5) Supporting advocacy or public interest groups
- (6) Public relations consultants
- (7) Paid advertisements in specialty or general media.

The primary method, employed by approximately three-quarters of the firms, is single-issue lobbying. This means that firms target a major issue and have their representatives write articles, testify before legislative bodies, and address interest groups presenting the company's views on this single issue.

At the same time, firms may also work through their trade associations on the same issue. More than two-thirds of the firms also use this technique. In some instances, it is not appropriate to work through a trade association on a particular issue—either because a trade association is not available or

the issue is not of sufficient interest to all members of the association, or the members do not agree on the issue—and firms will seek coalitions with other interested companies. Approximately two-thirds of the companies also use this method of affecting a public policy issue.

Those firms with political action committees (PACs) seek candidates who share the views of the company, and four out of ten firms say that this is an effective method of affecting the debate on various public policy topics. This technique has an impact on the success of the firm's single-issue lobbying effort and, in many companies, becomes an integral part of that effort.

Only a little more than a quarter of the firms say that they rely on advocacy or public interest groups to carry the burden. Those that do support advocacy groups nearly always do it in combination with lobbying and trade association efforts. A fifth of the firms also employ public relations consultants to help their own staffs deliver their message on issues. Only a minority, however, rely on paid advertising to sway public views on issues of concern to the company.

Forecasting Emerging Public Policy Issues

Companies were asked to forecast which of the various public policy issues they are currently dealing with—or perhaps entirely new ones—they believe would be of most pressing concern to them three years from now. Public affairs officers, who must often operate within short time horizons, were understandably reluctant to forecast what the top-priority issues would be in 1988. Nonetheless, they selected from the menu of issues presented in the survey those that they believe are virtually certain to be of concern to their companies three years hence. The issues identified are:

- (1) Tax reform
- (2) Deregulation
- (3) Federal budget deficit
- (4) Environmental protection
- (5) International trade
- (6) Health-care costs.

The time frame for the projected resolution of these issues varies greatly. Tax reform is perceived as an issue that will take a year or more to resolve—if it is resolved at all. Deregulation, by contrast, is an issue that is likely to be of concern, in the view of public affairs officers, for the "foreseeable future."

The survey finds growing optimism on budget-deficit reform due to the recently enacted Gramm-Rudman-Hollings bill. Environmental protection issues are seen as a long-term "sword of Damocles" suspended over most corporations, and the survey respondents are equally pessimistic about the resolution of international trade issues, forecasting a likely stalemate between the Congress and the Administration. They are, however, more optimistic about health-care costs and believe this issue may recede in importance by 1990.

Perspectives on Employment

by Audrey Freedman

Management Summary

Given at an International Seminar on Employment in Paris, this paper focuses on the probable trends in employment growth to the end of the century.

Productivity increases in the manufacture and distribution of goods will continue to reduce labor requirements.

Employment will continue to shift toward "intangible" production of services. Jobs will increase in

- business services that are purchased by goods-producing and service-producing enterprises.
- point-of-consumption work, such as retailing and restaurants.
- caring for people; protection and security functions; maintaining the quality of a crowded environment

Human Resources Program

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Introduction

In the summer of 1985, an executive of the French company L'Oreal, M. Jean Bounine-Caballe, came to The Conference Board to discuss future trends in productivity and employment. From these conversations there developed a view that advanced industrial societies are travelling along similar paths, particularly in their labor market and employment futures, toward the next century.

M. Francois Dalle, former Chief Executive of L'Oreal and President de la Commission Nationale de l'Industrie, convened

an International Seminar on Employment in Paris, October 23, 1985, to develop these points with particular regard to the French, Japanese, and American economies. The study below, which was given at that Liaisons Sociales meeting, will be published in France this year in a somewhat longer version, with more comparative French data. M. Dalle has permitted the author to publish the English version as a Conference Board Research Bulletin.

Employment Patterns and Shifts

Far from being calm and smooth, the United States labor market has been undergoing a series of "revolutions" that seem to be occurring at a faster and faster pace. Social changes, economic development in other parts of the world, government policy, and technological advances all have complex effects in the employment market—in how the U.S. population produces, and how it supports itself. It is impossible to take account of all these factors in analysing today's employment patterns, let alone in making forecasts. However, in looking toward the end of the 20th century, our perspective must include (1) some appreciation of the effects of technology; (2) the changing demographic and social patterns in advanced economies; and (3) the consequences of—and possible future course of—government activity.

Industrial Composition in 1985

There has been a long-term rise in the relative share of total employment engaged in producing intangible goods or "services." Prior to 1967, the employment shift to services was accompanied by a relative decline in agriculture. Since 1967, the shift has been accomodated by a relative decline in manufacturing. Employment is highly volatile in manufacturing and construction, falling sharply in recessions and then recovering. During the 1981-1982 recession, the steepest since the depression of the 1930's, there was a reduction of nearly 3 million jobs—most of them in manufacturing, construction and mining. The service-producing sector faltered somewhat from its growth trend, but did not shrink.

An increased share of employment in services has been associated with very advanced economic development by many

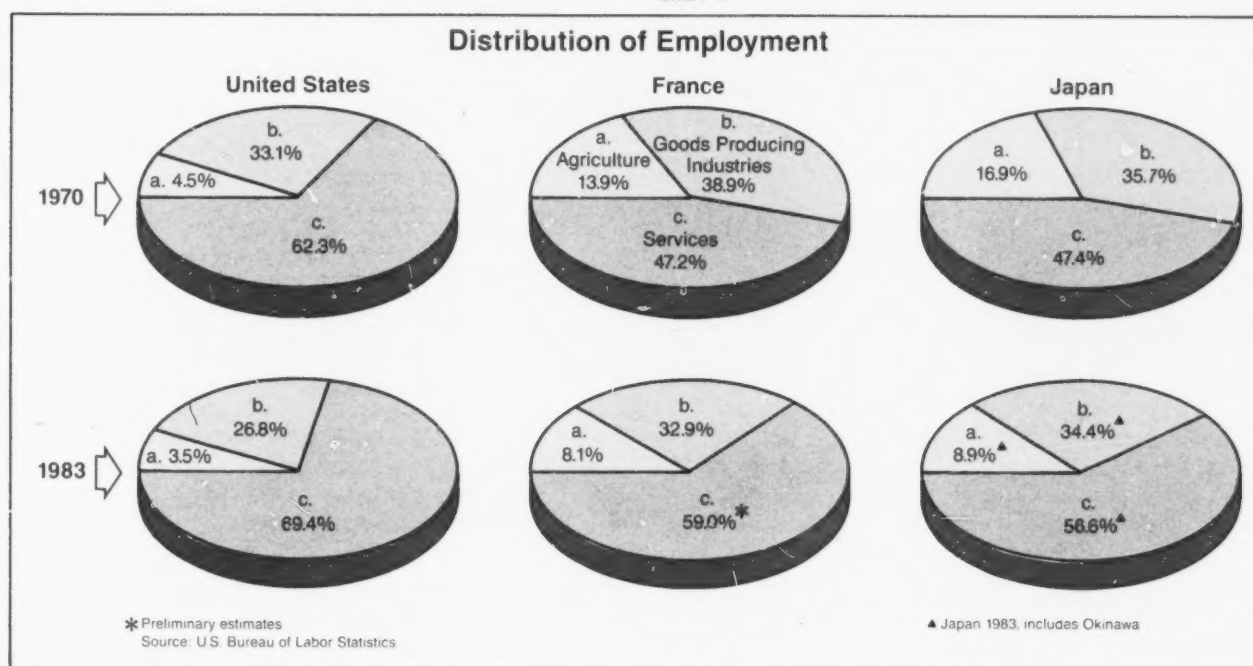
economists. It appears that technologically advanced economies are now growing chiefly in the service sectors, as Chart 1 shows for three countries.

The manufacturing sector is not monolithic, however. Beneath the summary data that show the same level of employment in the recent decade and a half, there has been considerable change. Steelmaking, clothing manufacture, footwear, textile employment have shrunk considerably. They may continue to shrink in the decade ahead. In the case of textiles, the shrinkage is partly due to gradual installation of advanced equipment, but—more importantly—to the importation of this labor intensive product from lower-cost producers. In the case of steel, employment decline is due to a number of causes, among them: overcapacity, growing substitution of alternative materials for steel, changing technology, and lower-cost competition from abroad.

On the other hand, employment has grown in some manufacturing industries. The nonelectrical machinery industry and electrical and electronics industry increased their post-recession employment to about 4.3 million in mid-1985. Both of these capital goods industries are expected to continue growing for the next decade, according to the United States Bureau of Labor Statistics.¹ This projection is based on continued defense buildup, and growing business investment in new equipment. However, a protracted recession could undermine

¹Personick, Valerie A., "A Second Look at Industry Output and Employment Trends through 1995," *Monthly Labor Review*, November 1985, p. 34. The Bureau of Labor Statistics issued new projections one month after The Conference Board paper was given. To the extent possible, the text has been harmonized with new BLS projections.

Chart 1.



the projected growth. Another cautionary note is the rapid growth in capital goods imports, substituting for United States-made machinery.

Agriculture. In the 20th century, this part of our economy has undergone the most thoroughgoing and constant technological change, productivity advances, structural change, and worker "displacement" of any sector. At the turn of the century, some 38 percent of United States workers were in agriculture; now, it is about 3 percent. Yet our farm production has soared. In fact, United States food production, especially grain, is our strength in exports. The United States is the world's largest exporter of agricultural products, selling some \$38 billion in world markets—about twice as much as the nearest competitor, France.² Toward the end of this century, biotechnology will have major effects on agriculture and on chemical industries linked with it. (See below, p. 10.)

Mining was the technologically transformed industry of the 1950's, and the shrinking industry of the 1960's. Then, in the 1970's, it grew rapidly in employment, due primarily to increased oil prices and increased world prices for other mineral resources. This industry has undergone waves of technological and structural change, and employment shifts that have attracted relatively little notice. Today, it employs about a million workers, about 60 percent of them in oil and gas fields. In the next decade, there may be little or no employment increase in mining.

Service-producing industries—employing nearly three quarters of the United States work force—are growing, and will continue to expand their share of job growth in the future. Within this broad grouping of industries, however, there

is a wide diversity of service "product," and different growth expectations.

Transportation and public utilities, including communications, employing about 5 percent of the United States work force, is growing very slowly. Withdrawal of government regulation in transportation (trucking, airlines, railroads) began at the end of the 1970's. The breakup of the communications monopoly, and deregulation of that industry, occurred in the early 1980's. The competition thus fostered has created some additional jobs, extinguished others—with a small net gain. However, the employment security formerly enjoyed in these industries has vanished. Union power to impose high, nationwide wage standards has also been forfeited to a competitive, market determination.

Finance. Banking, insurance and real estate services have increased steadily, and have raised their share of total employment to over 5 percent. (See Table 1.) Major technological change, in the use of computers and communications, has increased the productivity of financial services manifold. Yet demand for more and new services continues to increase employment. Part of the reason is that computers, which have cut deeply into clerical "back room" work, also have expanded the variety of services the industry can offer. As a result, more customer-contact workers are needed. This kind of shift, due to automation of a "production" process, is discussed further on page 13.

Trade. Employment in retail and wholesale trade, including restaurants, has been growing rapidly. Retail trade is also the largest employer of part-time workers. Much of the growth during the 1970's was due to expansion in the restaurant and "fast-food" industry. There was a readily available supply of young workers to staff the industry's growth in that decade. An even more important growth factor may be the decline in

²Culen, Eva, "International Dimensions of the Farm Business," *Economic Road Map* No. 1995-1996, The Conference Board, 1985

Table 1. Distribution of Employment in the United States

(in millions)	1984		1980		1970		1960	
	percent distribution		percent distribution		percent distribution		percent distribution	
Total working for pay ¹	106,746		102,076		81,184		66,910	
Goods-producing:								
agriculture ² and ⁴	3,108	2.9	3,067	3.0	2,964	3.6	4,557	6.8
mining	998	.9	1,027	1.0	623	.8	712	1.1
construction	4,316	4.0	4,346	4.3	3,588	4.4	2,926	4.4
manufacturing	19,590	18.4	20,285	19.9	19,367	23.9	16,796	25.1
Service-producing:								
transportation and public utilities	5,170	4.8	5,146	5.0	4,515	5.6	4,004	6.0
trade (wholesale and retail)	21,787	20.4	20,310	19.9	15,041	18.5	11,391	17.0
finance, insurance, real estate	5,665	5.3	5,160	5.1	3,645	4.5	2,629	3.9
services	20,662	19.4	17,890	17.5	11,548	14.2	7,378	11.0
government	15,968	15.0	16,241	15.9	12,554	15.5	8,353	12.5
military (in U. S.) ³	1,697	1.6	1,604	1.6	2,118	2.6	1,861	2.8
Self-employed ⁴	7,785	7.3	7,000	6.9	5,221	6.4	6,303	9.4

¹Sum of items below.²Includes self-employed in agriculture.³From Department of Defense.⁴From Current Population Survey.

eating at home that accompanies the greater involvement of women in the work force.

Growth in retailing, restaurants and "fast-food" outlets is sometimes decried by social commentators as evidence of decay. Others note that the work is low-paid and insecure. But as goods move from fabrication into distribution channels, and finally reach the point of consumption, they require more labor input. From the growing of wheat, to transporting, milling, packaging and distributing it, many advances have conserved labor: technology and management systems increased output without increasing employment. But making flour into a croissant and delivering and serving it in The Conference Board's snack bar is highly labor-intensive and resistant to mechanization.

Services. The largest increases in employment have been in this industry—but only in some sectors. *Personal services*, such as laundries, barber and beauty shops, seem stabilized at about a million employees. *Health services* grew very rapidly in the 1970's, and have reached a total of over 6 million employees. Cost-cutting efforts are affecting this industry's growth, and will continue to constrain and moderate the growth that might "naturally" have occurred as the United States population's average age increases. But employment will continue to rise in the non-hospital health care sector.

Business services is now the most rapidly growing sector. Some elements of this group include agencies that supply temporary workers, public-relations, consulting, computer-service, building-management, and protective services. Growth of business services is directly related to the general prosperity of other private-sector businesses. However, there seems to be

an additional factor creating extraordinary growth in the 1980's. This is a marked increase in incentives for contracting out, to business-service firms, work that might have been done "in-house."

Government employment has been relatively stable since the 1970's at 15-16 percent of total employment. It is expected to increase very slowly in the future, not quite maintaining that share for the next decade. Most of the 8½ million employed in education are local and state government workers. Due to the rising number of births in the 1980's, education employment will begin to grow, moderately, in the next decade.

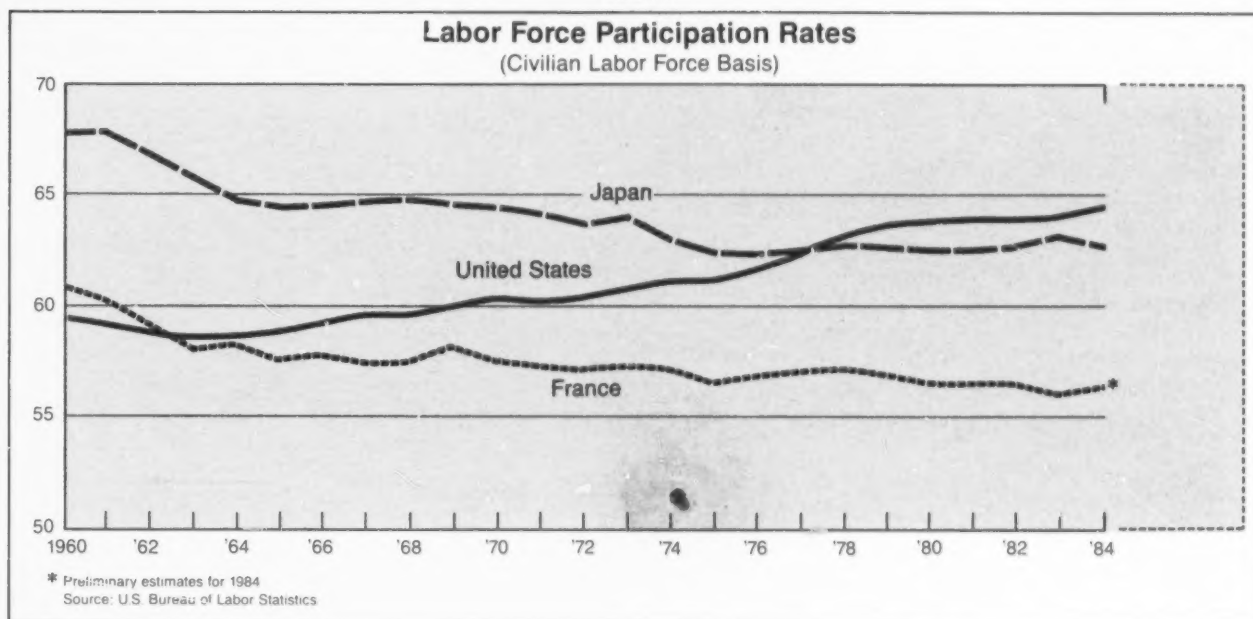
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The share of total employment in service-producing industries will probably increase further by the end of the century. Productivity increases in manufacturing will allow a rising level of output with about the same number of workers. Thus, the relative share of total employment in manufacturing will continue to decline from its current 18 percent to perhaps 15 percent by the end of the century.

Demographic "Revolutions"

The most dramatic change in the United States employment market has been a major increase in women's participation. Less than 40 percent of women were in the labor force in 1960; now their participation rate is just under 55 percent. The largest increase was among 25 to 54-year olds, who now have participation rates of over 70 percent. This growth is more pronounced than in other countries, although increased par-

Chart 2.



ticipation by women is occurring in other industrialized countries as well.

The increased participation of women reflects a major social change and, in turn, is contributing to further changes. It used to be typical for women to work for a time before marriage and child-bearing. Then, most women workers withdrew from employment, perhaps returning after the children were well into school years. This pattern had negative effects for women's pay and reduced the possibilities of careers; it diminished the returns to women's investment in education. The social shift of the 1970's was an increase in the *continuity* of women's participation in the labor market.

Most women work in the service-producing sector. Some of the employment opportunities created in this sector have occurred because tasks formerly carried on in the home are now done in the market. And, as more women work, more of these services must be purchased. Thus employment is increasing in restaurant, child-care, nursing and convalescent care, social work, and counseling services.

Primarily because of the increased involvement of women, the extent to which the population as a whole participates in the work force has been rising since 1964. Just under 65 percent of the adult population is now in the United States labor force—a somewhat higher rate than in France or Japan (Chart 2).

During the decade of the 1970's, the post-World War II "baby boom" generation began to enter the work force. The major increase in young adults coincided with increased participation of women to produce very rapid rates of labor force growth all during the decade. Large increases in the supply of labor diminished the incentive to conserve labor, that is, to increase labor's productivity. Much of the "new" supply (young entrants, adult women reentering the labor force) was absorbed in services such as retailing, restaurants and personal

services. These are labor-intensive industries: Output grew, but productivity did not. Consequently, the large increase in labor supply was absorbed.

Family Structure

Families and households have been growing smaller throughout this century. In recent decades, there has been a major increase in individuals living alone.

With rising rates of divorce, there is also increased likelihood that children will live for a time with only one parent, usually the mother. Of the 62 million families in the United States in the first quarter of 1985, 10 million were maintained by women—5.5 million of whom were employed. Married-couple families are likely to have both husband and wife employed. Of the 42 million families in the third quarter of 1985 that had some member employed, 28 percent were supported by husband only; the great majority were supported jointly or by women alone.¹

Unless there is another (now unforeseen) change in lifestyles, these trends will probably continue: Most wives will continue to work, whether or not they have children. Most working wives will have only one or two children. Many young children will experience a parents' divorce, and will live with their mother. Remarriage and formation of another family are likely. Continuity of support will probably continue to fall upon the mother. The expectation that they will be the family's support, along with consciousness of rising divorce rates, has itself contributed to the increased participation of young women in the labor force.

The effect of this pattern is not always appreciated in labor-force analysis. One set of data may clarify the point. In the

¹ *Employment & Earnings*, U.S. Bureau of Labor Statistics, October 1985, table A-71.

second quarter of 1985, there were 31 million families with children under eighteen years old. Twenty percent of those families were maintained by women, and nearly seven out of ten of the women were working or looking for work. The data are cross-sectional, reflecting only one point in time. Therefore, they only suggest the magnitude of the chance that a mother will be sole support of her children at some time.

Dependency

The high birthrates from 1947 to the early 1960's have produced a very large labor force to support the nonworking dependents in the population. As noted, the "revolution" that changed women from nonworking dependents into supporters has augmented the depth of producers per dependent in the present-day economy.

From now until the end of the century, the economic dependency ratio for children under age 16 is expected to remain about the same or decline slightly, because births will remain static (even though the "baby boom" women are now at a child-bearing peak). However, the economic dependency of the elderly will increase gradually in the 1990's, and more rapidly after the turn of the century. Current trends toward earlier retirement will exacerbate that growth in dependency—if they continue as the group reaching its late 50's begins to grow substantially at the beginning of the twenty-first century.

The age composition of dependency is depicted for France and for the United States in Table 2. While France had 1.3 dependents per worker in its economy, the United States had less than 1.1. Our dependency was composed more of the young (46 percent of the dependency) than was French dependency (41 percent).

There are at least two reasons for the higher dependency rates in France. One is a lower labor force participation rate (comprised of a major decline in male labor force participation,

Table 2. Ratio of Economically Inactive to Labor Force Participants, 1982

	France	United States
Total population	1.308	1.065
under age 16	.539	.489
age 16-64	.469	.360
age 65 and over	.300	.216

Source: Fullerton, Howard N. and John Tschetter, "The 1995 Labor Force: a Second Look," *Monthly Labor Review*, November 1983, p. 7, for the United States, and Bureau of Labor Statistics estimates for France provided to the author.

and only a moderate increase in female participation). A second major cause is entitlement to retirement pay: pensionable age in France is 60; in the United States generally, 65.

Focusing only on the elderly, it is clear that social decisions about retirement were made in an era when fewer people survived into very old age, and the economic burden appeared much lighter. Given "normal," socially accepted patterns and life expectancy in the United States today, less than half a lifetime is spent in employment. Until the twentieth century, there were very few people who experienced any "life after work." Children began to work much earlier and, once they began, they worked until they died. What dependency the society had to support was only its very young children.

In the short span of a century, life expectancy just about doubled in industrialized nations. At the same time, advanced economies created systems that culminated in a "worklife" of only half of that expanded life expectancy. It is likely that the problems caused by this revolutionary change will be the most serious social and economic stresses that we will face at the turn of the next century.

Productivity and Technology

Productivity improvement in the United States economy stagnated in the 1970's, rising at a rate of only .6 percent a year from 1973 through 1979 (compared to previous rates of about 2½ percent). Much research has been focused on the causes of this poor record, among them:

- sudden and severe energy price increases
- reduction in the growth of capital intensity
- decline in research and development investment
- surge of labor force growth
- increases in government regulation.

The energy shocks of the 1970's distorted economies, causing rapid inflation and a volatile economic and policy environment for business.⁴ The labor force growth rate and employment surged 2½ percent a year, making labor *relatively*

less expensive than capital, diminishing the incentive to conserve labor. During the 1970's, also, government regulation was extended to the areas of environmental protection and employee-health protection. Some capital investment that might have gone into more efficient production was instead directed toward reducing toxic emissions into the air and water, reducing the "dirtiness" of production facilities for the people working in them, and reengineering the product itself, in some cases, to make it safer for users. The many analyses have been inconclusive about the exact role that these factors played in the productivity slowdown of the 1970's.

The 1980's began with two recessions. Now, ten quarters into recovery, business productivity growth has averaged 2.2 percent at an annual rate. But productivity always surges in recoveries. In the five post-World War II recoveries that lasted as long as the current one, business productivity growth rates ranged from 3 to 5.1 percent.

⁴See, for example, Ezra Solomon (ed.) *International Patterns of Inflation: A Study in Contrasts*, Report No. 853, The Conference Board 1984, Chapter 2.

Table 2. Average Annual Growth in Manufacturing Productivity, and Related Measures, Ten Quarters after the Trough of Postwar Recessions
(percent change at compound annual rate)

<i>Recession trough quarter</i>	<i>Productivity</i>	<i>Output</i>	<i>Hours</i>	<i>Employment</i>	<i>Hourly Compensation</i>	<i>Unit Labor Cost</i>
1949 IV	3.8	11.1	6.9	6.0	8.4	4.4
1954 II	2.2	5.5	3.2	2.4	5.5	3.2
1958 II ^a	3.4	8.5	4.9	3.9	4.2	.8
1961 I	6.3	9.6	3.1	2.1	3.2	-2.9
1970 IV	5.9	10.2	4.1	3.1	6.2	.3
1975 I	4.1	8.3	4.0	2.9	8.2	3.9
1980 III ^a	4.2	6.6	2.3	2.0	8.4	4.0
<i>average cycle</i>	<i>4.5</i>	<i>9.0</i>	<i>4.3</i>	<i>3.3</i>	<i>6.3</i>	<i>1.2</i>
1982 IV	3.8	8.1	4.1	3.1	3.7	-.1

^a percent change, trough to peak (recoveries were less than 10 quarters in duration)

Source: Fulco, Lawrence J., "The Decline in Productivity During the First Half of 1985," *Monthly Labor Review*, December, 1985, p. 39.

Output gains are almost identical to those of past recoveries, but employment has risen much more than in the past. This development has a 1970's ring: Employment surges, productivity does not. Moreover, most of the growth of employment has been in the service sector. Manufacturing has recovered only 60 percent of the jobs lost in the last recession. From Table 3, it is clear that manufacturing employment and work-hours growth have been below average for recent recoveries, but even so, productivity increase has been relatively low. Only the recovery begun after the 1954 recession was as weak as the current recovery for manufacturing.

The increasing shift to services was not cited in the list of possible culprits causing a slowdown in productivity, because some services have higher rates of productivity growth: for example, communications, electric utilities, food retailing, banking. Other services, such as restaurants and beauty parlors, do not. The shift in what society consumes may make some contribution to the productivity slowdown. It is consuming less goods, more paid personal and group interaction. As goods-production is mechanized, labor moves into the distribution of goods. Next, it moves closer to the point of interaction with final customers. Productivity advances push labor intensity further and further toward personal interaction points. The implications of this movement for turn-of-the-century employment are discussed on page 13.

A projection of productivity trends for the next 15 years is particularly risky. We do not know why the productivity advance of the recent decade was so weak, so we cannot evalu-

ate whether the causes of that poor record are still present, increasing or diminishing. This uncertainty calls into question whether the causes of economic growth can be identified and their power quantified so close to the events. Those who are required to use some productivity "assumptions" in projecting United States economic activity and employment are using a range of estimates. But, significantly, that range is well below the historical trend (before the 1970's) of 2 to 3 percent a year. Loosely, the expected range of productivity growth is now from about 1 to 2 percent, for the decade 1985-1995.⁵ Beyond that, estimates are not made.

Technological Advance

The United States historically has prized invention, and felt secure in its technological leadership of the world. Recently, that edge has been fading in one sector after another. There is general agreement that this country excels at basic science of the "revolutionary" kind, such as lasers and recombinant DNA technique. Japan excels at the applied sciences, and especially in the development of new processes and commercialization of new knowledge.⁶ This suggests that some of the

⁵Personick, Valerie A. "A Second Look at Industry Output and Employment Trends through 1995," *Monthly Labor Review*, November, 1985, p. 34.

⁶Reflected recently at a "Symposium on Economics and Technology" in March 1985, sponsored by the National Academy of Engineering, the Center for Economic Policy Research, and the Departments of Chemistry and Chemical Engineering at Stanford University.

technologies discussed below may have an earlier impact in Japan than in the United States.

Robots have received the most popular attention—and indeed the vision of a factory with no workers is dramatic. However, adoption rates for robots have been slow, and the process of integrating them into a fully automatic, computer-controlled process is moving even more slowly. In a March, 1985 study (prepared by the Congressional Research Service for a subcommittee of the House Committee on Energy and Commerce), the following evaluation was made:

"Firms will have to raise large amounts of capital to replace even relatively small numbers of the labor force with robots. Capital cost constraints could be expected to hold blue-collar automation at well under the 75 percent level that has been cited by some as technologically possible. Even if the price of robots should experience dramatic declines, capital constraints could be expected to restrain the relative growth of robots...

"The cost to automate only 5 percent of the U.S. blue-collar labor force with robots could be greater than \$45 billion. Thus, under the (rapid adoption) scenario produced by the Leontief-Duchin study, the United States will be making significant increases in the size of its robot investments in the remaining part of this century. But even this sizable investment might not be large enough to automate and replace 5 percent of the U.S. blue-collar labor force."

Another study, done by the Society of Manufacturing Engineers and the University of Michigan, projects that about 4 percent of the work force will be displaced by 1995. By industry, displacement rates will be: 15 percent for electronics, 10 percent in primary metals, 10 percent in consumer nondurables, and 10 percent in aerospace.*

The Commerce Department's 1985 Industrial Outlook estimates that United States output of robots will grow to about 10,700 in 1989. That projection was based on an estimate of 3,500 units in 1984; but the Commerce Department now reports that United States-produced robots totaled 5,535 in 1984. However, an increasing share of the robotics market is going to Japanese and some European producers. It is possible that introduction of such factory automation is moving much more rapidly now, and in the near future, than is known.

Computer-aided design and manufacturing figures given by the Commerce Department show a rapid rise. Estimated "number of systems installed" were 12,000 in 1983, and are expected to rise to 63,000 annually by 1988.⁹ The combination of computer-control and robots, difficult to define in the abstract, is the heart of a workerless factory. It appears that the rate of transformation to such a production system will be very slow, at least until the mid-1990's.

⁹*The Computer Revolution and the U.S. Labor Force*, Committee Print No. 99-G, March 1985, published by the Subcommittee on Oversight & Investigations, p. 28

⁸Daily Labor Report, Bureau of National Affairs, Inc., Aug. 30, 1985, pp.A-1-A-2

⁹In 1985 *U.S. Industrial Outlook*, p. 21-7

Five types of technologies can be combined under the general term "programmable automation":

- robots
- computer-aided design
- computer-integrated manufacturing
- numerically controlled machine tools
- flexible manufacturing systems

Many companies introduce these technologies in piecemeal fashion, applying them to one major segment of manufacturing process at a time. However, the recent trend has been toward full-scale engineering of totally integrated, computerized systems, manufacturing products redesigned to the automated production process. Such a system would operate without production workers, with a few technicians to monitor its functioning. A report by the United States Congress' Office of Technology Assessment concludes that such facilities are "only a remote possibility" for the next 10-15 years. (However, the present author has seen just such a factory, run by Fanuc Ltd. in Japan.) The Office of Technology Assessment report evaluates employment impact as follows:

- Demand for engineers and computer specialists will increase.
- Numbers of production workers will decline. Drafters will "face diminishing opportunities." Clerical workforces will also shrink.

- Demand for upper-level managers and technical sales and service personnel will rise, although lower- and middle-management opportunities may fall.

"...These effects suggest major shifts in the occupational mix of manufacturing industries, especially metal-working. Overall, the salaried or white-collar work force will constitute a larger proportion of manufacturing employment, although it is not clear how much their ranks will grow in absolute terms. Programmable automation producers especially are likely to employ relatively few production personnel; their situation may signal future patterns among other firms and industries. Consequently, there will be few opportunities for people displaced from other manufacturing industries to move into jobs among producers of automated equipment and systems...

"In many ways, the shifts in occupations will not be straightforward. Some skills may only be required temporarily, after technology has been introduced but before further automation is achieved. For example, when automated equipment is used in isolated applications, there may be many needs for programming. But the integration of design with process planning and production systems reduces the need for programming, as does the development of standard, easy-to-use software packages. These 'short-term' phenomena may persist for many years, making it hard to plan for long-term employment change."¹⁰

New materials may have the biggest employment effect when they are substituted for an existing material. For example, as *composites* (fiber-reinforced plastics) begin to be used for aircraft "skins," they capture a substantial part of aluminum's

¹⁰*Computerized Manufacturing Automation: Employment, Education, and the Workplace*, Washington, D.C., U.S. Congress, Office of Technology Assessment, OTA-CIT-235, April 1984, p. 7.

market; when used for ships, *composites* reduce the need for steel.¹¹ As *advanced ceramics* are developed for use in cutting tools, ball and roller bearings, and engine parts, they reduce demand for specialty steels. Ceramic engines will probably be built before the 1990's, further diminishing steel's prospects for regeneration.

Genetic engineering is being applied to produce new pharmaceutical products for diagnosis, immunization, and treatment. One of the potentially most revolutionary uses of genetic engineering, however, is in the production of foods. In the next few years, bacteria that have been genetically modified may produce amino acids and vitamins for animal feed supplements, animal growth hormones, and vaccines. A single gene that confers resistance to herbicides may be transferred to plants that then need no cultivating (because weed growth is suppressed with herbicide).

The genetic engineering of plant traits seems farther off—in the 21st century. Developing cereal plants to make their own nitrogen fertilizer may not be accomplished directly, because

of the complexity of structure of the 17 genes that govern nitrogen-fixing process in bacteria. *Science* magazine says, "Even less is known about the genetic basis of other desired traits, including resistance to drought, heat, cold, salty soils, and other plant stresses. Researchers will have to identify the appropriate genes and determine how they work and are controlled... Culture techniques to select cells with the desired characteristics may succeed first, although the culture methods require that whole plants be regenerated from single cells."¹²

The effects of changing technology in food production will probably not be felt until the next century, but they are expected to be profound. The ability to produce nutrition with poorer soil, less rainfall, a shorter growing season, extremes of heat and cold will have effects of a geopolitical nature, not simply effects on industries such as chemicals, fertilizer, and so on. In the longer term, there will be consequences for population growth, the distribution of population over the globe, and the value of land. However far-fetched this may seem, a beginning has been made.

¹¹*Purchasing Magazine*, September 12, 1985, p. 2.

¹²*Science*, volume 216, June 18, 1982, p. 1306

The Operation of the Employment Market

The functioning of the labor market is a major influence on levels of employment, unemployment and unmet employer needs for workers. Labor market "signals" and transactions set wage levels, allocate employment geographically and by industry and occupation, and (theoretically, at least) insure that the skills of the work force are used in ways that produce maximum value.

Government Policy

Private investments by parents, and by individuals on their own behalf, comprise much of the total human-resource development activity of a nation. However, development of the population into productive citizens is appropriately a matter of public policy, as well. Edward F. Denison's studies of the sources of productivity growth in the United States economy 1929-1982 found that the quality of the labor force was a major contributor to national economic growth.¹³

Investment In Human Resources

Long before the contribution of human resource quality was quantified by Denison, however, American thinking linked education with progress. Public policy and general education have been closely intertwined throughout our history, and federal policy began to emerge more than a century ago. However, the link between government policy and job skills training has been uncertain, sporadic and politicized since the 1960's.

During the early 1960's, there was an "automation scare": concern that unemployment might follow from growing mechanization. This combined with Kennedy activism to create new federal policy: to subsidize local "programs" that taught job skills and employment behavior (such as punctuality), and also remedial literacy and mathematics. In many situations the programs were intended for people whose needs were great: the chronically unemployed, those who were in the secondary labor market. These were eventually called "anti-poverty" programs. Since development of the programs was local (though funding was mostly federal), there was opportunity to create a great variety of human resource investments, or improvements, depending on the needs of local populations. For example, there were programs tailored to young, rural poor; to laid-off foundry workers; to partially-employed miners in Appalachia; to engineers in a plant that lost a defense contract. There were supplementary educational enrichment programs for 4- and 5-year old children; and house-repair training programs that practiced on homes owned by the elderly.

The programs were changed, subtly but permanently, by the race riots involving young blacks in a number of places across the United States in 1967 and 1968. In the late 1960's, also, there was a growing dissatisfaction with United States involvement in the Vietnam War; young people were numerous (the baby boom had reached its late teens) and they were rebellious. In the ensuing national climate of unrest, what was available to be used where suppression was unthinkable? The human-resource programs, the anti-poverty programs. Quickly redirected, these human-investment activities became pacification programs, directed toward black unrest and youth unrest. More of the funding was used for "stipends," less and

¹³Denison, Edward F., *Trends in American Economic Growth, 1929-1982*, The Brookings Institution, Washington, 1985, p.30

less for job training. This transformation of purpose soon robbed the programs of their legitimacy, and began, by the early 1970's, to raise public cynicism about federal efforts.

In the early 1970's, decentralization became a favored policy. Now the Federal Government was to allocate funds to *state* and *town* governments, and these would administer their use. Inevitably, the real purpose was transformed again, and the programs became mere conduits for political patronage. Levels of public scorn rose further, and the effort was moribund by the mid-1970's.

Now, a decade later, there is only a small government effort for very low-cost training, directed by private businessmen and some local officials.¹⁴ Its focus is on economic development: providing very limited subsidies for job training to the businesses themselves, in the main. There was also, until recently, a program aimed specifically at workers who have lost jobs due to competition from imports. It provided extended unemployment benefits. As there is no national system of retraining and relocation, the program's retraining-relocation options were essentially unavailable, a dead letter in the law.

Government Intervention in Labor-market Operations

Government policy in most countries is involved in labor market operations and transactions, often designed to overcome market deficiencies. A United States example of this is government-run listings of job openings that are made freely available to job-seekers. This cuts the cost of employment search for individuals and makes more applicants available, sooner, to employers. Thus it reduces total unemployment by cutting the duration of job-seeking efforts. It may also optimize the "fit" of workers to employer needs, by enlarging the choices available to each.

Sometimes, policies inadvertently reduce the efficiency of the market, or even reduce employment opportunities. An example of the latter is minimum-wage regulation. Its purpose is to uphold employment "standards" by preventing employers from taking advantage of an oversupply of labor. However, minimum-wage laws also keep employers from creating jobs paying less than the prevailing minimum, although there may be work of lower value to be done—and there may be people who would be willing to do it. Minimum-wage regulation prevents such a transaction from taking place.

From time to time, other government program interventions attempt to counteract the effect of a negative policy. For example, there have been sporadic employment programs that provide subsidies (or tax deductions) to employers for payroll costs. These allow the employer to pay the minimum wage by supplying part of that cost with government funds. When subsidized wages thus overcome a minimum-wage regulation that diminishes employment opportunities, more jobs will be created. If the subsidies are made available only if a particular kind of worker is hired (say, a younger person), that worker carries an advantage in the labor market. This advantage could operate at any wage level, if it is not restricted. For example, workers determined by a government agency to have

been laid off because of foreign competition can carry vouchers that give them an employment advantage over other applicants.

These illustrations of governmental intervention in labor-market operations are not intended to suggest that the *level* of regulation is increasing in the United States. Instances of withdrawal of regulation can also be cited. For example, numerous state and local actions of two types have generated more employment:

- repeal of local ordinances and/or state laws mandating business closure on Sundays, or other hours regulation
- liberalization of occupational licensing and certification.

Probably tens of thousands of retailing jobs in supermarkets, appliance stores, and department stores have been created by the repeal of Sunday-closing laws. When a barber's license is no longer required, and the bureaucratic limits on total licenses issued are thus eliminated, more low-cost hair-cutting shops open, and employment increases.

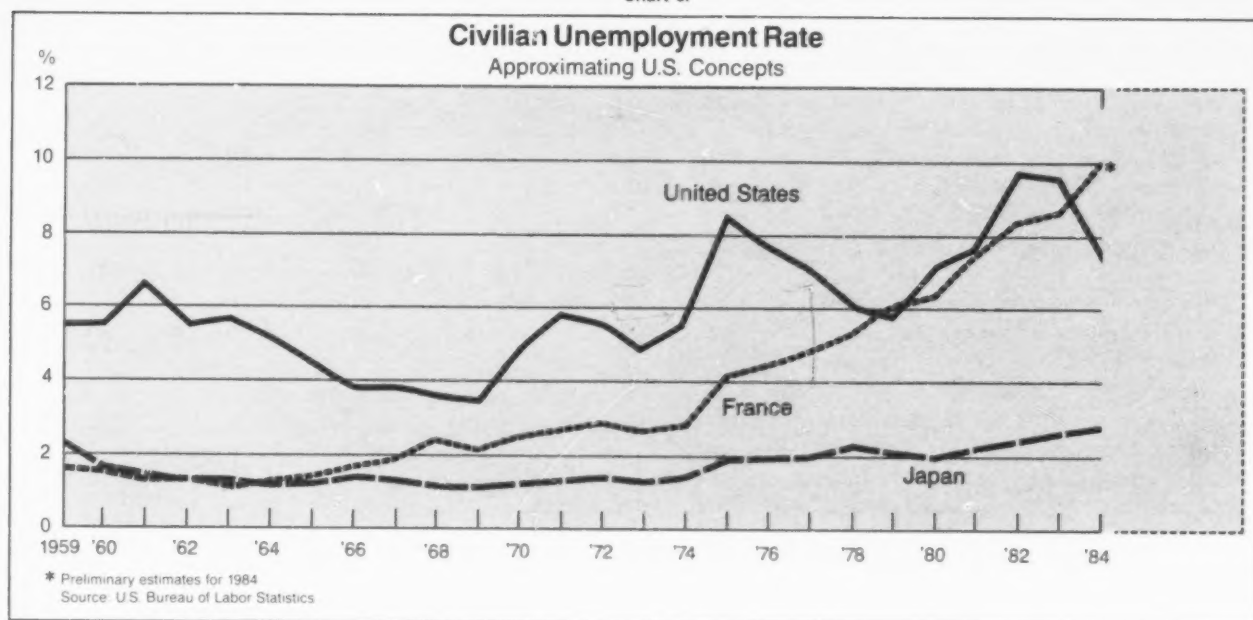
Government intervention includes income redistribution, modifying some of the harsh effects of unemployment. People who have lost their jobs are (for the most part) entitled to partial income support for a short period of time, usually six months. The limitations on amount and duration of payments are intended to deter dependency—at least they do not create incentives for prolonged idleness. The individual who has not become reemployed in the first six months after job loss, and falls into poverty, then may enter the public-welfare system at very low levels of support. (However, the "able-bodied" sometimes do not qualify for welfare.)

There is a great deal of variation among state programs. As a generalization, the system does not provide retraining or relocation, or extend payments for these constructive approaches to unemployment. Unemployment compensation was designed for temporary and minimal income support, and that is all it does. In a few states, some retraining "programs" are linked with unemployment benefits. It is uncertain whether the government's flickering commitment to employment training will grow again and respond to the double challenge of higher joblessness and higher skills requirements.

One barrier to training programs is particularly serious. To be efficient and cost-effective, the argument goes, training should be specifically focused on jobs that are in high demand. Preferably, training should only be offered for a job that employers cannot fill. Training funds and resources are not efficiently used when they are expended on non-existent job vacancies. This requires more foresight and flexibility than governmental agencies can develop. Nor can employers foretell what their most pressing job-skill needs will be. As if this basic problem were not a sufficient barrier to national training programs, there is another: This is the drive, always present in public efforts, not to subsidize privileges for one group at the expense of all. So, training programs must just provide an extra skill at the margin. Under this kind of philosophical constraint, the Reagan Administration's "Job Training Partnership Act" is currently offering in some places, under private business leadership, job training costing a few hundred dollars. The constraints of efficiency (linkage to immediate

¹⁴Berenbeim, Ronald, *Company Programs to Ease the Impact of Shut-downs*, Report 878, The Conference Board, 1986

Chart 3.



job placement) and low per-capita expenditures combine to limit the program's applicability to people who barely need it anyway. In this sense, the training program operates "at the margin." This characteristic hinders its usefulness either as a system for massive national adjustment to new technology, or national response to endemic long-term unemployment.

Trends In Unemployment Experience

Over the past sixteen years, the United States has experienced four business cycles with the attendant rising, then falling, unemployment levels. However, it appears that our lowest level of unemployment, at the recoveries' peaks, has been increasing. (See Chart 3.) When unemployment due to recession was completely overcome, it reached a low point of 3.5 percent in 1969. Then a recession, and recovery, with unemployment at a low of 4.9 percent in 1973. Another recession, then recovery, and unemployment fell to 5.8 percent. Currently, the low point will probably be about 7 percent for 1985.

To date, the factors contributing to this increase in "structural unemployment" have not been fully identified. One study has found that much of the increase is due to a rise in long-term unemployment:¹⁵ those who have lost jobs do not easily find reemployment. There could be a multitude of causes. If the job-information system is not providing enough information on vacancies, or is not spreading it widely enough for easy use, this could be a contributing cause. In an age of communications technology that is very nearly revolutionary, our employment information system may be weak—an anomaly. Another factor may be the amount of income available from sources other than employment. However, the reduction in this

kind of support under the current Administration suggests that nonwork income is a lesser factor, not an increasing one. A related cause of higher unemployment might be increasing amounts of employment in the underground economy—some merely "off the books," some illegal. Yet an individual so engaged seems unlikely to report himself as searching for work. Therefore, even if underground employment is growing, it is not adding to the trend toward rising rates of unemployment in recovery periods.

It is also possible that the amount of basic education and training available is insufficient to fit all of today's work force to the needs of employers. Some large employers, when their needs are great, operate extensive training programs. Usually, these are designed to "upgrade" and retrain their existing work force. But an industry in competitive difficulty, or other decline, does not have funds or the incentive to retrain its workers so they can easily find a job elsewhere.

Compared with European countries, our unemployment seems low. It is also more volatile. Our unemployment rates are far above those in Japan, however. Many analyses have commended the system of lifetime employment that a few of the largest Japanese enterprises offer to their male employees and the general culture of security that makes employment duration in Japan much higher than in the United States. While employment security may be beneficial to morale, it probably accounts for little of the low unemployment levels in Japan. Some part of lesser unemployment there is due to withdrawal from the labor force.¹⁶

¹⁵Sider, Hal, "Unemployment Duration and Incidence, 1968-82," *The American Economic Review*, June, 1985, p. 469

¹⁶The measure of unemployment, by U.S. concepts, is the proportion of people actively searching for work, among those in the labor force. The labor force is the total of those working plus those searching. Thus an unemployed person who stops searching has left the labor force. The unemployment rate is lowered by this departure.

Employment Flexibility

Certain kinds of employment are inherently less stable and secure than others. In the next decade, it seems very likely that total hours of work in such jobs will increase as a proportion of total United States employment in recovery years, but be volatile and fall in recessions. Production workers in goods-producing industries have their hours reduced, then are laid off in recessions. In the professional-technical-and-clerical areas, too, there are increases and decreases in the amount of work needed. While companies do not easily "lay off" these workers, they seem more and more to be using a system that allows them to reduce white-collar work in another way.

This is done by relying on "contingent" workers. For example, a company might add clerical workers on a day-to-day or week-to-week basis, hiring them from a temporary help agency. It might obtain technical staff this way, too. In the United States, there are now about 700,000 workers supplied by temporary help agencies. The firm might also contract for engineers or chemists from a technical-employee firm, for periods of months or years. It might have self-employed technical writers working on specific projects, such as instruction manuals or an annual report. The firm might contract its ad-

vertising and promotional campaigns out to independent companies or partnerships; it might also hire a public relations service. Payroll and accounting functions can be contracted to a data processing service. And so on. Finally, the firm might hire more part-time staff whose hours can easily be increased or cut, or eliminated entirely.

Most of the employment created by these actions on the part of (for example) an electronics firm will be external to the firm's core payroll. The hours will be recorded mainly in an industry called "business services" and its subindustries such as personnel-supply services. There has been extraordinary growth in the "business services" industry: from 2 to 4.1 million employees between 1974 and 1984. Employment in personnel-supply services more than tripled in that period, rising from 266,000 to 828,000. In 1985, with overall employment growth slowing, these services continue to grow.

The objective is flexibility for employers. United States enterprises are not so regulated, nor so security-ridden, that they cannot expand employment rapidly in recovery. They do just that. The other side of this coin is that, in recession, employment falls the more easily both for blue- and for white-collar workers, especially in contingent-employee relationships.

An Impressionistic Discussion: Where Will Employment be Tomorrow?

The three preceding sections have moved, gradually, from factual descriptions toward inferences. This final section will move into overall impressions of future trends. The underlying facts are given, but the future must be imagined.

Total United States employment in goods-producing industries will probably remain at about the same level as today: 28 million workers. However, overall output in the goods sector will increase. Productivity advances will continue to permit rising output without commensurate increases in the labor force.

Employment will Grow at the Point of Consumption

The United States labor force will continue to grow from now until the end of the century, though at a slower pace than during the 1970's. The increase in total number of people employed will appear entirely in service-producing industries. Productivity improvement will continue in many service-producing industries, particularly because of broader use of computer-communications systems. These are also likely to transform industries, not merely improve their conventional systems of operation. In services such as utilities (electric and gas), communications and transportation, the amount of "blue collar" production work—already quite low—will continue to fall because of technology. The amount of sales, customer service, and other personal-contact work will remain the same or increase.

In a general way, this is what is happening to employment in advanced industrial economies: Productivity increases due

to technology—the deepening of capital—have allowed more and more physical output with less and less direct labor. Yet labor requirements continue to increase overall. They are pushed "forward" in the production sequence. Now, they are reaching the point of customer contact, the point of usage of the physical product.

For a simple example: Very little labor is required to produce cotton—growing, harvesting, cleaning, bleaching, spinning and weaving it. In recent decades, we have mechanized the steps of fabricating such a final product as bandages, sterilizing and packaging them—little labor there. Shipping now requires some labor; but better management, technology and sharper competition are cutting those labor hours, too. When that bandage reaches the hospital, labor input begins to grow. It must be stored, ordered and dispensed to the appropriate hospital floor and patient. The application of the bandage, the changing of dressings, is not only highly labor intensive—it requires advanced training to bring this cotton to use on a post-operative patient. Nor is this the end:—The doctor and the nurse are going to instruct the patient how to bandage his own incision for the next week.

The example illustrates the kinds of employment that are directly related to the consumption of things. And increasing amounts of that employment are in so-called "service-producing" industries. Yet they are jobs that have to do with the final (or next-to-last) point in the goods chain: consumption. Transportation and wholesaling are in the next-to-last

step. Marketing and retailing employment are in the last step. So are restaurants, broadcasting and barber shops. If we could create a new industrial taxonomy, this category would be "industries that distribute and aid in the consumption of things." These jobs are only distantly related to goods-producing industries. They will continue to increase in the future.

Employment in Caring for People Will Grow

Apart from consumption activity, there is another general characteristic of advanced economies that creates jobs: We are increasingly a crowded and complex society. At the turn of the last century, the United States was less crowded, more stable, and in many ways its families were far more self-sufficient than today. Looking at the increase in service employment from this angle, one can see the reasons for growth in the "helping professions" and employments: The less stable family is contracting out what was traditionally done at home, and these changes are creating new needs. The growth of these professions is a transfer, to market employment, of functions that were once done on a nonmarket, interpersonal basis in the family and community.

There are thousands of school counselors and "youth advisers" to guide young people—over and above their teachers. There are child psychologists, family-court social workers, housing project "youth directors," remedial reading assistants, recreation organizers, and play-group monitors. Day care is a fast-growing industry. All of this service employment is fairly recent in its development, and is expected to grow even though birth rates and the youth population will not.

Among adults, there is also a trend for work once handled within the family or community to be "professionalized". Employers have alcoholism programs, using counseling professionals on staff, and referring alcoholics to outside psychologists (and facilities). We hire "professionals" to tell us how to dress; to arrange parties; to decorate offices, hotels, and homes; even to develop a social or public image for us. We use vacation planners, wedding arrangers, diet advisers, exercise tutors, debt counselors, and caterers. We depend upon an extensive health care industry and growing preventive and wellness industries.

At the far end of the age progression, care for the elderly occupies a rising number of professional and nonprofessional workers. Even though the dependency level in the United States is low, and will begin to grow only toward the end of this century, the *care* of dependents seems increasingly to be "market" work, and institutionalized work as well. That is, it is work done in institutions or businesses or in market systems (such as visiting nurse agencies), rather than on an individual basis (such as household help). Thus employment in caring-for-people industries will continue to rise.

Protection Work will Continue to Expand

A more crowded, less stable society also requires more workers who protect people and property. Some of these jobs, easy to identify, are in government: police and fire services. There are private guard services, employing over 400,000. More

difficult to find in the data are the thousands of jobs that involve public protection in a broader sense. These are people who monitor toxic emissions, public-health authorities, water and sewer inspectors, food and drug inspectors, public authorities who check business practices and equipment from weights-and-measures bureaus to bank monitors and auditors. Parts of the accounting firm industry are in protective work, and the law connected functions including court and prison systems. Air travel security personnel, not identified and counted separately, are also directly involved in protection work. This kind of protective work is increasing in advanced economies, and it occupies hundreds of thousands of technicians and professionals. Although the jobs may be described in such a way as to imply that they fall in the caring-for-others category, their purpose is protection of the public, so we lump them in the group with police, fire and guard services.

Finally, there are millions of jobs that are not purely "protective," but that are developing some protective elements. This cannot be quantified, but can be observed. There is a receptionist in the lobby of a company, a plant, or an apartment building. There is an "appointments desk" in the lobby of an office building, or a newspaper, a foundation. There is an entry person at a college dormitory, and a door watcher in the library, the dining hall. There are more and more of these reception facilities, employing more and more people, whose jobs—more and more—involve what might be called "soft security". They are gatekeepers and recorders of the presence of others in a closed environment—closed for protection from casual entry.

Sustaining Quality in a Crowded Environment: Cleaning It

There is one more category of work that is growing: cleaning up the advanced society. Here is work that is barely noticed, but is increasing nonetheless. The rubbish collectors, streetsweepers, hotel maids, window washers, restroom attendants, building custodians, orderlies, dishwashers, busboys, and cleaning crews of all kinds of facilities, from hospitals to airports to airplanes. In the future, the numbers of people involved in this kind of work will increase, as we expend more of our affluence on maintaining the quality of a crowded public environment.

All three categories of work—caring for others, security, and cleaning—are pure service work, unconnected to goods production. They are really *beyond* the point-of-consumption jobs mentioned at the outset as the "growing end" of material production. They are also impossible to automate (though they may use some advanced technologies, such as video cameras). Many are relatively low-paid; and some employ large proportions of minorities, women and immigrants.

Thinking about the future of employment in a technologically advanced society, we characteristically project requirements for engineers, chemists, technicians. Then we look at the small numbers yielded by such an analysis and ask: "Where will the millions who would ordinarily go into factories, or offices, find employment? Will there be nothing for them to

do? Will we have a nonworking class and just a small number of technicians doing all the work?"

The answer is no. The future of advanced industrial economies is that rising productivity in manufacturing will allow a slow rise in output with the same number of workers as today. Yet production and consumption of services will continue to increase rapidly and to proliferate in variety. More and more employment will focus on maintaining and increasing the qual-

ity of life—with more services, and not so much more goods. The rising level of service employment will be in the four general groups described above. These are: (1) work at the point of consumption of goods and services—the personal interaction point; (2) work involving care—health, psychological, custodial, social; (3) protective work; and (4) cleaning. These are the jobs that will accommodate the gradual rise in the labor force between now and the end of the century.

Research
Bulletin

No. 193

The Conference Board
70th Anniversary

R4105-29.64 U
(A)
5/86

Summer Youth Employment: 1986 Edition

by Wesley Etheridge

Management Summary

- **Modest Increases**

With the exception of New York and Philadelphia, public-private coalitions in 14 major U.S. cities reported only modest increases in the number of youths hired during the summer of 1985. The coalitions placed 10,000 more youths than the previous year.

- **Foresee Little Growth**

The majority of coalition administrators foresee little or no growth in the number of placements for 1986.

- **Food, Clerical and Retail Jobs**

Most of the youths found jobs as fast food workers, clerical aides, and retail sales clerks.

Corporate Relations Program

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YOUTH EMPLOYMENT PROGRAMS in 14 major U.S. cities placed a total of 73,107 young people in summer jobs in 1985—an increase of 10,106 (approximately 15 percent) over the summer of 1984. Administrators of these employment programs—which are run by private-public coalitions—report that the increase in jobs was due to earlier recruitment and planning, better coordination between schools and the private sector, and increased funding from foundations and the Job Training Partnership Act (JTPA).

Predictions for the summer of 1986, however, are not rosy. Most of the administrators foresee no growth in placements in 1986. About half forecast a leveling off of job opportunities, and several predict a decline.

Chief among the reasons given for this perspective by administrators of these programs is the slowing growth of the economy in general. According to the General Manager of Baltimore's Blue Chip-In: "This program does not create jobs as much as it creates access for youth to fill existing jobs. The number of jobs available is more a function of the economy than of the program's success."

Other reasons cited by administrators for predicting minor, if any, increases in job placements include a decline in federal support and the expiration of the Targeted Jobs Tax Credit

About This Survey

This is the fourth annual survey of summer job opportunities for young people that are made available through public-private coalitions in 14 major U.S. cities.

For this year's survey, Philadelphia was substituted for Pittsburgh because of the difficulty of obtaining relevant information from the latter city. The remaining cities have been used in prior studies and were chosen to represent a cross-section of U.S. urban areas in terms of size, location, and economic condition.

(TJTC)¹ which is considered by some to be a major incentive for hiring young people.

Table 1 compares the number of youths placed in summer jobs during 1983, 1984, and 1985. The majority of the cities, with the exception of New York and Philadelphia, reported only modest increases in placements. New York, which

¹The Targeted Jobs Tax Credit legislation, which gave an 85-percent tax credit for the first \$3,000 of wages paid to youths hired during the summer, expired in December, 1985, after Congress failed to extend the program for 1986. A National Alliance of Business lobbyist informed The Conference Board that the bill—which has the support of both houses of Congress—is being considered for reauthorization as part of a package of tax-credit bills.

Table 1: Summer Job Placements: 1983-1985

	1985	1984	1983
Baltimore	4,004	3,969	3,780
Boston	2,320	1,939	1,181
Chicago	1,038	1,877	2,591
Cleveland	1,727	1,341	1,007
Detroit	662	527	400
Houston	6,021	6,000	5,000
Los Angeles	10,897	10,113	7,432
Miami	3,939	3,338	2,010
New York City	31,584	26,542	19,798
Omaha	358	344	370
Philadelphia	4,845	1,530	N.A.
Richmond	820	890	1,177
San Francisco	1,389	1,340	1,262
Seattle	3,503	3,251	2,604
	73,107	63,001	

Table 2: 1985 Placements in Private and Public Sector

	Private Sector	Public Sector
Baltimore	2,681	1,323
Boston	2,210	110
Chicago	1,038	0
Cleveland	1,056	671
Detroit	62	600
Houston	6,021	0
Los Angeles	10,897	0
Miami	3,264	675
New York City	31,584	0
Omaha	358	0
Philadelphia ¹	4,845	0
Richmond	510	310
San Francisco	1,172	217
Seattle	440	3,063

¹The actual number placed in Philadelphia was far greater than that reported—25,739. But of that figure, almost 15,000 were youths previously placed by the city's Office of Employment and Training. The city administration closed that office in 1985, and transferred all its program obligations to the Private Industry Council. Another 6,000 youths were hired by private businesses independently of PIC operations.

launches an extensive marketing and recruitment campaign each year, upped its placements by 5,000 youths. In Philadelphia, the Private Industry Council (PIC) assumed all the program functions of the city's Office of Employment and Training—which has gone out of existence. Philadelphia also received significant increases in foundation and private sector funding. Other cities that improved their performance include Los Angeles, which placed 780 more youths; Miami, which found 600 more jobs; and Cleveland, Boston and Seattle, each of which secured placements for 300 additional young people. Chicago and Richmond placed fewer youths.

The majority of the jobs made available were as retail sales clerks, hotel and recreational park aides, aides to construction and maintenance crews, clerical employees, and fast food workers. (See Table 3.)

Summer youth-employment programs do not focus primarily on high school dropouts. Data provided by the program administrators indicate that 70 percent of the youths placed were high school students, 25 percent high school graduates, and the rest high school dropouts.

Youth Unemployment

Despite increases in the number of summer placements made for 1985, high unemployment continues to plague youths around the country. According to the U.S. Bureau of Labor Statistics (BLS), in August, 1985, the national unemployment rate was 6.9 and the teenage rate was 15.1 percent. For black teenagers, the unemployment rate was 32.4 percent. These data

represent an improvement over the rates for the summer of 1984: 18.4 percent for all youths and 42.3 for black youths.

Critics of the official figures continue to take issue with the basis for the BLS data, however. The Full Employment Action Council (FEAC)—a coalition of labor, religious, civil rights and youth advocacy groups—argues that the BLS unemployment statistics do not include those persons who "have been discouraged from looking for work." As a result, FEAC contends, "actual" unemployment was much higher than described by BLS. It argues further that more youths are joining the ranks of the "underemployed," that is, people who are forced to accept part-time jobs because they cannot find full-time work.

Another factor influencing the officially-reported decline in youth unemployment for the summer of 1985 is a decline in the youth labor force (defined as ages 16 to 19). Because fewer youths entered the labor force during the summer of 1985, fewer were officially looking for work, so fewer were defined as unemployed. Data released by BLS show that in July 1985, the youth labor force totaled 3.6 million—a decrease of 600,000 from the previous year. The drop in the number of youths looking for work reflects a decline in the youth population.

Increased Roles of States, Localities and Private Industry Councils

The Administration's emphasis on reducing the role of the Federal Government in social programs has motivated an increasing number of states and localities to create and administer their own youth projects. A dozen states and 15 localities today run "conservation" and community-improvement programs without the benefit of federal aid.

The New York City Volunteer Corps employs high school dropouts as aides in shelters for the homeless.

The California Conservation Corps, which is funded by California's Natural Resources Department, puts teens to work in public parks.

The Northwest Youth Corps, which operates in Eugene, Oregon, does not provide jobs itself but refers youths to private businesses for environmental improvement. For example, logging firms have used the corps to assist in replanting forests after timber harvests.

In an innovative approach, New York City has granted a real-estate developer permission to build extra floor space in a condominium development in exchange for funds to create jobs for disadvantaged youths. With the cooperation of the Transit Authority and the Transport Workers Union, the city will use the money to hire young people to spruce up subway stations.

Private Industry Councils (PICs) are also increasing their participation in summer youth employment programs. According to the National Alliance of Business, in 1983 only 8 percent of the nation's 594 PICs operated summer youth employment programs; the figure climbed to 27 percent in 1984, and 36 percent in 1985. It is through such programs that many young people initially obtain work-related skills and habits.

Table 3: Where Youths Were Placed in 1985 (Percent of Placements)

	Clerical	Fast Food	Community Improvement	Delivery	Retail and Other ²
Baltimore	30%	24%	12%	2%	32%
Boston	52	0	0	0	48
Chicago ¹	62	8	0	10	20
Cleveland	6	25	39	3	27
Detroit	7	0	60	2	31
Houston	10	45	0	25	20
Los Angeles	9	26	0	0	65
Miami	12	17	21	15	35
New York City	28	13	0	9	50
Omaha	14	17	21	3	45
Philadelphia	N.A.	N.A.	N.A.	N.A.	N.A.
Richmond	N.A.	N.A.	N.A.	N.A.	N.A.
San Francisco	45	1	0	1	53
Seattle	36	6	6	2	50

¹Based on estimates from 1984 figures.

²Maintenance, repairs, tutorial, social service, etc.

In a program jointly operated by the Private Industry Council of Southern Connecticut, Inc. and Pitney Bowes, Inc., many disadvantaged teens in that state secured their first jobs. Targeting youths between the ages of 14 to 22 from low-income families, the Summer Jobs For Youth Campaign solicited contributions and job pledges from several private businesses.

In Philadelphia—which is included in The Conference Board's tabulation for the first time, replacing Pittsburgh—the PIC assumed all functions of a city employment agency, perhaps the first PIC to do so in a major city.

One of the most successful programs in the nation is administered by the New York City Partnership. Combining the efforts of the New York Chamber of Commerce and Industry, the Economic Development Council, and representatives of several unions and corporations, the Partnership provided 31,584 jobs for disadvantaged youngsters in 1985 through its five-year-old Summer Jobs for Youth program.

Legislative and Administrative Developments

JTPA and Job Corps Reduction

President Reagan reduced allocations for the 1986 Job Training Partnership Act's (JTPA) summer youth-employment programs. The federal agencies affected by the cut include the Departments of Labor, Health and Human Services, and Education. Under the current appropriations bill, summer youth employment will be cut by \$100 million. In addition, the President's fiscal 1986 budget would eliminate the Job Corps program and close all Job Corps centers by June 30, 1986. Alleging the persistence of severe youth unemployment, proponents of the Job Corps argue that, while the program is expensive, because it combines remedial education and training with work experience, it is one of the best vehicles for youth employment.

Subminimum Wage

The Reagan administration's controversial subminimum-wage proposal—which would enable employers to pay teens a minimum hourly wage of \$2.50 during the summer months rather than \$3.35—will be put forth again for the summer of 1987. Opponents argue that paying teens a lower wage would result in unequal pay for youths doing the same jobs as adult coworkers, displacement of older workers, and an increase in the number of "discouraged" workers. Opponents also maintain that reducing the cost to employers will not substantially increase job opportunities. In the United Kingdom, wage subsidies are paid to employers for hiring young workers, but the subsidies "failed to significantly improve youth employment," according to a British economist who studied the program. The subsidies are about to be phased out.²

Only one of the 14 program administrators responding to The Conference Board's survey supported the idea of a subminimum wage. Expressing the view of most, the Seattle administrator said a subminimum wage plan would be "very negative. It would make it difficult to recruit, would have a negative impact on the community's view of our program, and would not allow youths to earn enough money."

The Department of Labor is reportedly considering "sweetening" the bill by including additional funds to train unskilled young workers, and by increasing penalties on employers who displace older workers.³

²"Youth Wage Subsidy Program Fails To Boost Employment in Great Britain," *Daily Labor Report*, May 3, 1985, p. A-11.

³"Where Do We Go From Here?," *WorkAmerica*, National Alliance of Business, October, 1985, p. 2.

Conservation Corps

In April 1985 the House Education and Labor Committee approved the American Conservation Corps Act of 1985, a program which would hire teens to build and improve public lands, roads and parks. No Senate action has been taken as of this writing. A similar bill, approved by both Houses of Congress in 1984, had been vetoed by President Reagan, who contended that it was "unnecessary and costly."

Program Effectiveness: Two Views

Two evaluations of youth employment programs were aired in 1985. William H. Kolberg, President of the National Alliance of Business, referring to recently released JTPA performance figures, praised the program, noting that "JTPA works, and it works well." The figures showed that 62 percent of those youths who participated in JTPA got jobs.⁴ Kolberg also indicated that the National Alliance of Business believes that the Targeted Jobs Tax Credit has also been instrumental in increasing youth employment. He concluded that "with TJTC hires doubling each year, we continue to believe that it is an efficient means of encouraging employers to hire people who traditionally find it hard to break into the job market."⁵

⁴Recent research from The Conference Board points to increasing focus by the private sector on youth and family-related problems. Boeing, for example, has developed a series of videotapes showing interviews with workers in entry-level jobs in various career areas. The tapes will be distributed to high schools. See Kathryn Troy, *Meeting Human Needs: Corporate Programs and Partnerships*, The Conference Board, Report No. 881, 1986.

⁵"Targeted Jobs Tax Credit Deserves Renewal," *WorkAmerica*, September, 1985, p. 2.

On the other hand, a panel organized by the National Academy of Sciences, in a report entitled *Youth Employment Training Programs*, declared that "large scale government job training programs for poor youths have had only limited success in increasing employability and preventing socially destructive behavior." The panel's study indicated that while huge efforts were made by private industry and state and local agencies, "not much was learned about how to reduce the long-term employment problems of American youth."⁶

As in so many other matters, the differences in these two points of view may reflect either that they are not responses to the same aspect of the problem, or that they do not cover the range of opinion.

Asked to comment on ways to improve the programs with which they are associated, the administrators of the 14 public-private coalitions made the following recommendations:

- The business community, they suggested, should become more involved and committed to youth employment by working closely with the schools and providing increased funding.
- Local government should also provide additional funding and promote job readiness training in the schools.
- The Federal Government, on the other hand, should increase its involvement by retaining the Targeted Jobs Tax Credit and relaxing its income limits; by allowing those youths who were eligible for the tax credit during the summer to maintain their eligibility throughout the year; and by providing more oversight and sharing information on the programs that it funds.

⁶Kenneth B. Noble, "Impact of Youth Job Projects Is Declared Limited by Panel," *New York Times*, November 13, 1985.

The Conference Board
70th Anniversary

Corporate Financing in International Markets

by Patrick J. Davey

Management Summary

- Surveyed companies see a global market for capital emerging. Almost half of them have already tapped it and many of the remainder intend to in the future. The principal attractions: cost effectiveness and expansion of financing sources.
- Participants rely heavily on intermediaries to gain entry into international financial markets. Relationship, reputation, and expertise are the factors weighed most heavily in selecting underwriters for offerings and bankers for foreign loan syndications.
- Much in the way of experimentation has been attempted in international markets. Swaps, involving exchanges of interest rates, currencies, or both and note issuance facilities are two of the most popular innovations embraced by respondents.
- Government restrictions, capacity limitations and queuing requirements are among the barriers participating companies encounter in attempting to access certain foreign financial markets. But these are coming down and their removal is encouraging the internationalization of capital markets.

Financial Management Program

Profile of Participants

Respondents' Line of Business	Use of International Financial Markets		
	Number of Participants	Number of Nonparticipants	Total
Manufacturing (and mining)	28	36	64
Utility	11	13	24
Service	5	2	7
Financial	5	1	6
Transportation	1	4	5
Retail	2	—	2
Total	52	56	108

All six financial institutions have total assets well in excess of \$1 billion. Annual volumes of the 102 nonfinancial respondents range from just under \$100 million to more than \$20 billion. Only 2 transact yearly sales of less than \$100 million; 24 have sales in excess of \$5 billion. The following tabulation classifies international market participation according to volume categories of the 102 queried nonfinancial companies.

Annual Sales of Responding Nonfinancial Companies	Number of Participants	Number of Nonparticipants	Total
Under \$100 million	—	2	2
\$100—\$499 million	3	14	17
\$500—\$999 million	5	12	17
\$1—\$5 billion	20	22	42
Over \$5 billion	19	5	24
Total	47	55	102

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Introduction

Not many years ago, U.S. corporations in need of external financing turned routinely to domestic sources of capital—investment bankers, insurance companies, commercial banks and the like—to satisfy their requirements for funds. As times have changed, so have the financing habits of some concerns. Nowadays, it is not unusual for companies to adopt a more global view toward funding sources. Indeed, it is becoming almost commonplace to see symbols for yen or pounds and names of foreign underwriters in tombstone advertisements for domestic issuers.

A number of factors have contributed to this emerging global market for capital. Principal among them: the maturation of the Euromarket (see box); the increasing accessibility of various foreign domestic capital markets, such as that of Japan; the removal of tax barriers to investment; the differences in investors' standards in various markets; and, importantly, the introduction of innovative financing techniques including "swaps" facilitating currency and interest rate exchanges.

This survey was undertaken to review recent and planned international financing practices of domestic corporations. Questionnaire responses from senior financial executives in 108 U.S. companies, together with information developed in interviews with a limited number of these respondents and other knowledgeable executives, form the cornerstone of this report.

The most significant findings are that: (1) The Euromarket and foreign capital markets function largely as debt markets. (2) Larger companies are more likely than smaller ones to raise funds in international markets. (3) Most companies, regardless of size, are aware of and enthusiastic about, financing opportunities abroad. (4) Multinational companies are not the sole users of international financial markets; and (5) Obstacles—for instance, queuing requirements in some countries—slow, but do not block, the development of a global capital market.

Thus far, participants have entered the international markets with a variety of debt offerings. They have not issued equities although some intend to offer convertible securities in the future.

Among respondents participation in international markets increases directly with sales or size. The second tabulation in the accompanying box makes the relationship evident.

Many of those queried, whether or not presently borrowing outside the domestic market, plan to consider foreign sources when the need for funding next arises. Such companies intend to explore all the alternatives in their quests for financial support.

Regular reliance on international markets by utilities and financial institutions, whose activities are largely, if not entirely, domestically focused, shows that foreign financings are hardly the exclusive domain of multinational companies. Concerns are paying less attention to geography and more to attractiveness of deals in arranging financings.

Barriers continue to retard access to certain foreign markets. But they are falling—those of a tax nature, for example — and their removal, according to respondents, is doing much to spur the internationalization of the capital markets.

Evolution of the Eurocurrency Market

From humble beginnings less than 40 years ago, the Eurocurrency market has grown apace. Estimates place total 1985 Eurobond issues at over \$125 billion.¹

What accounts for this rapid development? The Eurocurrency market sprung up following World War II when the dollar assumed its role as the premier trading currency. Eastern European countries, especially the Soviet Union, needing dollars to finance imports from the United States but fearing dollar accounts might be impounded if held in banks subject to the jurisdiction of the United States, started depositing dollars with European banks. Later, in the 1960's, low-interest rate ceilings imposed on United States banks prompted depositors to look elsewhere for higher returns. Many turned to European banks, which, free of interest rate restrictions and reserve requirements, were able to offer depositors greater inducements. The opening of foreign branches and subsidiaries by U.S. banks provided an additional spur to the growth of the Euromarket.

Further impetus came from the market's relative freedom from regulation. For example, the speed with which borrowers can enter the market proved a major attraction. Indeed, shelf registration, recently introduced in the U.S. capital market, is an attempt to accelerate the domestic underwriting process and make it competitive with that abroad.

Efforts to deal with the U.S. balance-of-payment deficits through regulations and the accumulation of great wealth by oil-rich nations also contributed to the growth of the Euromarket. So did the market's demonstrated ability to fill a variety of financing needs quickly and efficiently. More recently, easing of controls by various governments and refinancings prompted by interest rate declines have fueled market expansion.

¹World Financial Markets, Morgan Guaranty Trust Company of New York, January 1986.

Recent and Proposed International Financings

Fifty-two, of the companies surveyed, or just under half, have engaged in international financings of one or more kinds during the past two years. All of these fund-raising efforts have been debt oriented. As Table 1 indicates, bank borrowings loomed large among recent international financings accomplished by participants in all business categories. Besides term loans, respondents have arranged revolving credit and standby agreements with international banks. And a number also have borrowed from foreign banks in local currencies to support the working capital needs of subsidiaries.

While those queried have obtained some capital in foreign domestic capital markets, far more emphasis was placed on fund-raising efforts in the Eurocurrency market through Euronote and Eurobond offerings. (See Glossary). Euronote transactions included zero coupon, floating rate and note with warrant issues. Eurobond offerings included Eurosterling, Euroyen and zero coupon bonds. Foreign capital market borrowings consisted of issues in Canadian dollars, Swiss francs, Japanese yen and English pounds.

Many responding firms state that international financing plans for the next two years are moot, or that all available sources including those abroad will be considered as their funding requirements become apparent. Even among the twenty-six companies with fairly definite near-term intentions of participating in international financings, nine are uncertain as to

what forms fund-raising efforts will take (Table 2). Members of this undecided group make it a practice to monitor international markets and seize opportunities when matches between needs and circumstances arise.

Foreseen financings are, for the most part, new borrowings along conventional lines. Exceptions are the plans of four companies to establish revolving underwriting or note-issuance facilities (discussed on page 10). These arrangements and swap transactions, which are suggested in Tables 1 and 2 (by the foreign capital market financings), are among the quite numerous innovations now achieving prominence in international debt markets.

Line of business does not appear to have influenced the type of borrowing accomplished by respondents. Utilities, for example, spread their fund-raising efforts among credit and capital markets just as manufacturers did. Similar approaches were taken by participating retail, transportation and service companies suggesting a broad pattern of planning flexibility designed to permit the reaping of favorable funding arrangements wherever they existed.

Future plans, as shown in Table 2, indicate that responding companies will continue to tap a variety of international financing sources. But early indications are that greater overall reliance will be placed on raising funds through security issues than through straight bank borrowings.

Table 1: International Financings (1983-1985) by 52 Participating Companies

Financing Approach Employed	Number of Companies						Total
	Manufacturing	Financial	Retail	Transportation	Utility	Service	
Foreign bank borrowings	23	4	2	1	13	6	49
Euronotes	13	2	8	1	5	1	30
Eurobonds	9	6	1	—	3	3	27
Foreign capital market borrowings	5	3	3	—	1	1	13
Dual currency borrowings	1	1	1	—	1	—	4
Other	1	—	—	—	—	1	2
Total	52	16	15	2	28	12	125

Table 2: Proposed International Financings (1985-1987) by 26 Participating Companies

Financing Approach Contemplated	Number of Companies						Total
	Manufacturing	Financial	Retail	Transportation	Utility	Service	
Eurobonds	5	3	—	—	1	1	10
Foreign capital market borrowings	2	2	—	—	2	1	7
Foreign bank borrowings	4	—	—	—	2	—	6
Euronotes	2	1	—	—	1	2	6
Revolving underwriting or note issuance facilities	2	1	1	—	—	—	4
To be determined	9	3	1	—	—	1	14
Total	24	10	2	—	6	5	47

Reasons for International Financings

Whether for completed or planned international financings and regardless of type of financing, companies usually give cost effectiveness, expansion of funding sources, or both, as explanations for tapping overseas markets. Other reasons, occasionally offered for using international financial markets, include: the opportunity to obtain arbitrage profits; the less restrictive nature of borrowing covenants; the desire to hedge overseas assets; freedom from domestic regulatory restraints; term, tax and foreign-exchange considerations; the easier, less voluminous documentation required for issues; and the expectation that foreign borrowings will, by producing favorable publicity, increase demand for the equity of debtors.

All-in (total) costs for Eurocurrency and foreign capital market issues comprise interest rates, underwriting charges and, often, swap fees. Underwriting fees abroad tend to be higher (perhaps 2 percent versus .5 percent, for example, on a \$200-million bond issue) than those assessed domestically. And currency swap fees, perhaps .3-.5 percent of the amount involved, also add to costs. How, then, can international financings offer lower total costs to issuers? The answer lies in coupon or interest rates that on occasion prove sufficiently lower than domestic rates to offset the domestic market advantages of less costly underwriting fees and absence of swap outlays. Total savings of 25-100 basis points have been realized on international financings.

Why are lower interest rates sometimes available to U.S. borrowers in international markets? There are several reasons including foreign investors' general distrust of the securities of unstable governments and fondness for the securities of "name" U.S. companies. These inclinations occasionally help produce a premium—lower coupons—for the issues of well-regarded U.S. companies, especially when offered in bearer form. (Under the Tax Reform Act of 1984, domestic corporations are now empowered to issue bearer bonds directly abroad.) Of course, lower inflation rates, more favorable economic conditions, and governmental policies that are advantageous to business sometimes result in lower interest rates being available in foreign capital markets—that of Japan, for example—than in the United States. Lower costs of capital coupled with innovative packaging of loans also enable some international banks to offer competitive rates.

Many financial executives of U.S. companies have broadened their horizons beyond customary borders to ensure an adequate supply of funds. Past volatility in the domestic market has induced some to look elsewhere for assistance. So has the drying up of demand for certain kinds of issues. Recommendations of investment bankers, many of whom have adopted a more global outlook in arranging financing, have spurred others to use the international financial market. And the successful experience of peers has prompted still others to look to the Eurocurrency market as a means of diversifying or expanding financing sources.

Of course, some companies are attracted to the international financial market by the hedging and arbitraging opportunities it offers. Protecting a long position in foreign assets by bor-

Glossary

As with many areas of finance a special language has sprung up to describe various aspects of international fund raising efforts. Definitions of some of the terms commonly encountered in such dealings follow:

- Eurodollar—dollar on deposit in a bank located outside the United States.
- Eurocurrency—currency on deposit in financial institutions located outside the country of the currency's issue—for example, sterling on deposit in a French bank.
- Eurobond—long term obligation issued in countries other than the country in whose currency it is denominated.
- Euronote—short term obligation issued in countries other than the country in whose currency it is denominated.
- Eurocurrency market—sometimes simply referred to as the Euromarket. It is a network of world-wide banks at least a portion of whose deposits are denominated in currencies other than that of the countries in which they are located.
- Eurodollar bond—dollar denominated bond issued outside the United States.
- Euroyen bond—yen denominated bond issued outside Japan.
- Samurai bond—long-term obligation of a non-Japanese company denominated in yen and issued in Japan's capital market.
- Bulldog bond—long term obligation of a non-British company denominated in pounds and issued in the United Kingdom.
- Dual currency obligation—long term bond that is denominated and pays interest in one currency but that is redeemable in another—for example, a bond that is denominated in Swiss francs and pays interest in Swiss francs, but is redeemable at maturity in U.S. dollars.
- ECU—acronym for European Currency Unit. A basket of currencies composed of specific quantities of the currencies of member countries of the European Community.
- Foreign domestic capital market—the national market of a country when used by an issuer domiciled in a different country—for instance, the Swiss capital market when being used by a U.S. firm.
- LIBOR—London Interbank Offered Rate—is the interest rate at which banks in the London Euromarket offer funds to other banks.
- Tranche—portion of an entire financing—for example, a \$500 million borrowing might be drawn down in five distinct parts (tranches) of \$100 million each. Or an issue distributed in three markets would have a tranche for each.
- Zero coupon bond—long-term debt instrument priced substantially below par at issuance, which pays no interest, currently. Investor returns come from redemption of the bond at par at maturity or from its sale prior to maturity whenever it sells at a price in excess of the issue price.

rowing in the currency in which they are denominated appeals to some. Using zero-coupon Eurodollar note proceeds to purchase United States Treasury notes to create profits attracts others!

¹Ann Monroe, "Financial Plays," *The Wall Street Journal*, January 16, 1985, p. 1.

The following comments by participants present representative explanations for the use of the international financial market:

"The Eurobonds were issued to obtain the lowest dollar—equivalent interest rate available with 'properly priced' instruments and to increase the company's exposure to the Eurocapital markets. The debt currency swaps were utilized to hedge our net asset positions in the respective currencies, and the Eurosterling bond also was utilized in part to hedge our net asset position in sterling. The U.S.-dollar financing and standby facilities were also the most efficient and cost-effective vehicles available. The foreign local financing for foreign needs is usually the most efficient from interest rate, logistic and foreign-currency-exposure management perspectives."

Assistant treasurer, a service company

"The company has pursued a strategy of entering the global capital markets as a means to expand its investor base and, at the same time, achieve the lowest possible cost of funds. Since foreign investors' market outlook and yield requirements may differ from U.S. investors' perceptions and requirements for various reasons, the Euromarket from time to time may offer cost savings, compared to comparable note issues in the United States."

Director-corporate financing, a financial organization

"Both financings were cost-effective means of raising long-term debt and tapping new sources of capital. The terms of both financings (interest costs, maturity and financial covenants) were materially more advantageous than those available in the United States capital market."

Director-corporate finance, a mining company

Dependency on International Markets

Among 32 companies providing details on the extent of their reliance on international markets for financing, foreign borrowings range from 1 percent to 50 percent of total borrowings with a median of 20 percent. Table 3 indicates how these companies expect their relative dependence on the Euromarket and foreign domestic capital markets to change by 1990.

Fifteen of those making a forecast see their reliance on international markets intensifying by 1990. They offer several reasons for this expectation, including the trend toward deregulation in several foreign domestic capital markets (which makes them more accessible); the attractive cost opportunities presented; the continued development of creative techniques that will foster the use of offshore markets; and the growing perception among investment bankers that a worldwide capital market exists. The treasurer of a service company, whose debt raised in foreign markets accounted for 11 percent of its total indebtedness at year end 1984, explains why the organization may increase its dependence on foreign markets:

"We expect that this percentage could increase by 1990 because of the relatively good rates in Europe and the relaxation of withholding tax regulations. For large corporations, debt issuance is considered on a global basis and not necessarily on a national basis. We expect that we may have a debt issue in

Table 3: Expected Future use of International Financial Markets, 32 Companies

By 1990	Number of Mentions
Reliance expected to increase	15
Reliance expected to remain steady	8
Reliance expected to be shaped by future developments	8
Reliance expected to decline	1
Total	32

the future that will be sold in both the overseas and domestic capital markets."

One-fourth of those making predictions anticipate little change in the extent of their reliance on international markets during the next five years. Another 25 percent believes future developments—market conditions, interest and exchange rates, for example—will determine whether greater use will be made of offshore markets. Only one company expects reliance on foreign financings to fall. It plans to reduce the amount of debt in its capital structure—a strategy likely to prompt domestic equity financing and discourage borrowing from any source.

Companies not Using International Financings

More than half (56) of the companies queried have not as yet used the international markets to secure financing for corporate purposes. But several of them report borrowings in local currencies by—or on behalf of—foreign subsidiaries, usually to avoid the exchange risk involved in dollar financing. Reasons advanced for not raising funds in offshore markets, listed in frequency of mention, are:

- Nature of financing requirements
- Preference for domestic funding sources
- Insufficient economic inducements
- Problems with available maturities

Many of the nonusers of international markets indicate that they are generating sufficient funds internally to make external financing, domestic or foreign, totally unnecessary. Others state that very little in the way of external support is needed to maintain operations and, what is, is readily obtained through established domestic sources.

Some of those that express a preference for domestic funding point to satisfaction with earlier financings to explain their position. Others maintain that less than top-rank debt ratings impede their access to international markets.

Several fail to find economic advantages in overseas markets. A manufacturing company, for instance, took competitive bids on a \$100-million, 10-years issue, in both the domestic and Euromarket, and found the U.S. market provided a savings of 6 basis points. And a few indicate that domestically issued commercial paper is less expensive than borrowing short-term abroad.

Maturities for Eurobonds, usually five to twelve years, are shorter than those for their domestic counterparts whose terms

commonly extend from fifteen to twenty-five years, or even longer. This difference turns a number of those queried away from international markets. "We want to match our liabilities with our assets which generally have 40-year depreciable lives," says the assistant treasurer of a utility in pointing out one of the reasons the company has not raised funds in foreign markets.

Lack of familiarity with the working of the international financial market dissuades some companies from approaching it. Conviction that they are not well enough known and respected by investors abroad convinces others to confine financing efforts to the domestic marketplace.

Possible Future Use

Forty-four of the companies not presently raising funds abroad believe they may attempt to gain access to the international markets in the future. In fact, twelve of them are contemplating such financings at the present time. Many of the remainder report that they will not hesitate to make entry when

company financing needs can best be filled in international markets. For example, the vice president and treasurer of a diversified manufacturing company states:

"We view Eurodollar or foreign-denominated bonds, loans, and so on, as a potential source of financing that can be used to augment domestic borrowings. The decision to borrow short or long term in either the domestic or foreign markets is governed primarily by one or more of the following criteria: (1) the effective all-in interest cost, (2) maturity, (3) prepayment rights, (4) foreign-exchange exposure as it relates to non-U.S.-dollar funding options, and (5) any unduly restrictive covenants which might hamper future expansion of operations."

The dozen that do not anticipate accessing the international markets give several explanations for their expectations. Among them: regulatory constraints that prevent their taking advantage of windows (advantageous placement periods); conservatively oriented boards of directors, that look askance at all forms of foreign financing; and financial conditions within the company that make the probability of raising external funds from any source in the foreseeable future remote.

International Financing Procedures

When a company's management decides to raise funds in international markets, it must determine whether to proceed through a public or private offering, or through borrowings from banks. Either way, the company must first address the task of getting ready for market entry. Then it must go about the job of appointing a representative to act as an intermediary in securing the desired financing from investors. Finally, the company must cooperate with its chosen representative in the selling effort.

Preparing to Enter the International Market

Participants in this survey stress that international financial markets are "name" markets. International investors are not so much concerned about the quality of the paper they are purchasing (although credit standing does have relevance) as they are about the reputation of its issuer.

To prepare for market entry a company must first become familiar with the workings of the Euromarket and foreign capital markets. And then it must get itself known in the proper circles.

How can these challenges best be met? While company approaches vary with knowledge and exposure levels, the following general course of action is suggested for newcomers by an experienced investment banker:

"First, you should detail a couple of your brighter associates to learn all about the technical aspects of issuing Eurobonds, interest rate and currency swaps, and revolving underwriting facilities. With this knowledge under their belts they will be in a good position to decide what best suits the company's requirements and whether or not to pursue international

financing possibilities further. A visit to an investment banker's offices in New York or London could be helpful in this respect...

"After the technical side is absorbed, it is important for members of the international study team to get themselves into the flow of market information about Euroissues and swap opportunities. This can be done in various ways, by studying interest rate and foreign-exchange data on a regular basis, tracking and comparing international market opportunities with domestic alternatives, and by having periodic conversations with investment banking and capital market representatives of the various firms with which you are in touch. In any event, members of the team should develop a couple of 'insider' contacts with whom to discuss issues and rates on an ad hoc basis.

"The next step, assuming the decision is now made to plan for an international issue, is to focus on preparing the market for your entry into it. This can involve several months, and we recommend that it have three parts to it. The first of these is to plan an equity-information meeting both at luncheons and on a one-on-one basis with leading portfolio managers in London, Zurich, and possibly one or two other cities. As a part of these meetings, visits can be scheduled with some leading Eurobond houses to acquaint or reacquaint them with the company and to tell its 'story' from the debt-financing point of view.

"The second part might well be a bank borrowing or (arranging a standby credit facility such as a revolving underwriting facility). This will tend to bridge the gap between the first part, and the third—which is to select a lead manager for a prospective Eurobond issue, and several of the co-managers that the lead manager will propose to distribute the issue. This advanced selection, which we call presyndication, preferably

Table 4: Criteria Influencing Selection of International Underwriters

<i>Criterion</i>	<i>Number of Mentions</i>
Established relationship	25
Unblemished reputation	16
Demonstrated expertise	14
Outstanding distribution ability	10
Cost competitiveness	9
Adequate strength	6
Creativity in packaging deals	5
Other ¹	2
Total	87

¹Competitive bidding and security specialization

would be made before the time of the information meeting, but otherwise not long after. Once the management group is chosen, we like to organize a presyndication dinner in London for first-time issuers in the market, where representatives of the company can meet face to face with the group that will be underwriting its issue. This meeting usually occurs two to six weeks prior to launching of the issue, but it may be longer if the right market conditions do not materialize in that interval. The main idea behind presyndication is to get a top-level commitment from the whole group to back the issue, and to use the opportunity also to make sure they understand all the 'selling points' associated with it. Then, with the group ready and primed, one waits for the right moment, usually the early phase of a market rally or when an attractive swap opportunity is presented, and pops the deal in at relatively short notice. Thus, the issue is launched before the end of the market rally, when conditions are less favorable, into the hands of underwriters who are fully prepared for it and who have had time to organize their sales efforts. We have used this procedure for new issuers many times in the past and have almost always found it to produce very satisfactory results for all concerned."²

Selecting Underwriters and Lenders

Ten years ago, a panel of United States companies was asked what criteria they employed in choosing underwriters for their predominantly domestic issues.³ The characteristics most prized by that group included: outstanding reputation, proven marketing capability, counseling expertise, innovative financing ability, ready accessibility, quality personnel and reasonable cost structure. Overlapping but not identical requirements exist today for investment bankers handling international issues. Companies taking part in this survey expect chosen investment representatives to demonstrate some or all of the attributes outlined in Table 4.

²Address on "Satisfying Corporate Financing Requirements" by Roy C. Smith, General Partner, Goldman Sachs & Co., at The Conference Board's 1985 West Coast Financial Conference, San Francisco, April 25, 1985.

³Patrick J. Davey, *Investment Banking Arrangements*, Conference Board Report No. 681, 1976.

Many companies prefer to arrange international financings through organizations with which they have had satisfactory dealings in the past. A history of well received underwritings whether in the domestic market, the international market, or both, gives them confidence that planned offshore financings will go smoothly. So such companies often arrange overseas financings through their intermediaries for domestic issues: investment or commercial banks, many of which have overseas representation through subsidiaries, affiliates or joint ventures. (See accompanying box). On occasion, of course, foreign banks, with which ties have been previously established, are chosen as lead managers.

An unblemished reputation is frequently mentioned as a desired trait in investment bankers. Companies fear that any breach of integrity on the part of their representatives in financial markets would redound to their own detriment. So they are careful to select intermediaries known for uprightness in handling not only underwritings but also personnel, consulting and other support matters.

A proven track record is another criterion many consider when making a choice among prospective intermediaries. For example, a U.S. company contemplating an offering in the Bulldog market might eliminate as candidates all bankers that have not successfully negotiated several placements in the United Kingdom regardless of their accomplishments elsewhere.

Ability to place an issue in accordance with a client's wishes—for example, with a broad mix of institutional investors—is another characteristic that companies value highly in the investment banker chosen to market their issues. Past accomplishments in this regard are weighed heavily by those to whom efficient distribution is a major factor in the selection process.

Competitive pricing of services and the requisite financial strength to ensure completion of underwritings are other characteristics greatly appreciated by companies seeking international intermediaries. So is innovativeness in designing and carrying out financings.

International Intermediaries

The Glass-Steagall Act, which bans commercial banks from engaging in basic corporate domestic underwriting activities, has failed to put a damper on these banks' international fund-raising efforts. In overseas capital markets, affiliates of several large domestic banks have provided first-rate competition not only for the established European merchant banks but also for Wall Street's investment banking firms.

Demonstrating inventiveness, tractability and eagerness, the foreign arms of domestic commercial banks have obtained a goodly share of mandates from firms anxious to raise funds in the Euromarket. As intermediaries they have arranged a variety of financings in the international marketplace including foreign currency offerings, swaps and commercial paper arrangements. The success of their efforts is reflected in the standings of lead managers where they hold a number of prominent positions.¹

¹See, for example, "Euromarket Borrowing," *Euromoney Corporate Finance*, February, 1985, pp. 9-20.

For several participating companies the selection process does not end with the choosing of a lead manager for an issue in the international market. As the following comment by the treasurer of a participating service company makes clear, opinions on the makeup of the overall underwriting group are sometimes offered:

"Recently, we have limited the selection of lead manager for debt issuance to those bankers that we currently utilize in other areas. We select the lead manager from within our banking group on the basis of experience and price for the specific debt offering we are considering. Once the lead manager is selected, then that manager typically has the freedom to select the underwriting syndicate. However, we will suggest other bankers with whom we presently have relationships be part of the underwriting syndicate."

In selecting banks to lead foreign loan syndications, most participating companies say that the same criteria used to choose underwriters apply. Some, however, put greater emphasis on the importance of an existing relationship in naming a lead bank. And for others the focus is, in the words of one chief financial officer, "more on traditional banking strengths compared to capital market strengths."

Bringing a Deal to Market

From start to finish a successful Eurobond issue can be completed in about a month. The process involves announcement of the issue, formation of a syndicate, completion of a road show by company executives and lead managers, preparation of the issue for listing, agreement on pricing, offering of securities and payment for them.

The lead manager or, as sometimes called, managing underwriter, of an international note or bond issue assumes several responsibilities. Included are: negotiation of the amount, conditions and timing of the offering; participation in the preparation of an information bulletin or prospectus; arrangement of a management group and underwriting syndicate; and coordination of all distribution efforts.

Provided the issuing company and chosen lead manager reach agreement on the key ingredients of a proposed financing—type, amount, approximate price, fees and the like—a written mandate is given to the lead manager to proceed. At this point, legal, accounting and other needed specialists are invited to participate in the process. The information these experts develop is often incorporated in the prospectus for the issue.

Unless the offering is expected to be quite moderate in amount, inducing the lead manager to assume complete underwriting responsibility, others are invited to participate and an underwriting syndicate is formed. Such syndicates facilitate marketing, spread risks (and profits), and encourage intermediaries to include one another in future deals any of them may lead.

Besides the lead manager a syndicate may include one or more co-managers, a number of underwriters and, if the issue is large, a selling group. The management team usually commits jointly and severally to buy the entire issue, but only after

lining up a sufficient number of underwriters to dispose of it. In addition, managers usually work out an agreement among themselves to define limits of individual responsibility. Members of the selling group do not have legal underwriting responsibility, that is, they are not bound to purchase proportionate shares of issues that go unsold in original offerings. However, their selling commissions could be threatened by exclusion from future syndications should they fail to perform as expected.

Pricing (i.e., establishment of the rate of interest to be paid by the issuer,) is probably the single most difficult aspect of an underwriting of debt securities. Issuers want the lowest possible interest cost; investors, the highest return. Underwriters strive to reconcile these conflicting objectives without damaging their own positions. These efforts are not always successful. For example, early in 1985, a number of Eurodollar bond issues were offered with coupons considerably below those attached to similar issues in the domestic market. The result: Issuers were pleased but underwriters were bruised because they were forced to absorb substantial portions of these issues into their own portfolios as investors turned away from them in search of higher returns elsewhere.

In the case of a syndicated Eurocredit, the lead bank also plays an important role. It assembles the other members of the syndicate, managing and participating banks; prepares a placement memorandum describing the financial condition of the would-be borrower and terms of the proposed credit; and markets the loan.

If the loan is fully underwritten, the lead and managing banks agree to provide the total amount of the requested loan. To keep the commitment, the lead bank will usually offer for placement more of the loan than it intends to distribute, realizing that not all banks approached will choose to participate. When the placement is complete, the lead bank and managing banks may retain 50 percent or more of the credit on their own books.

Term loans are the usual products of Eurocredit syndications. While many of these borrowings are amortized over their lifetimes, some have so called bullet repayments in which the entire loan is repaid at maturity. Arrangement ordinarily consumes from two to twelve weeks.

Pricing of Eurocredits is related to the borrower's credit quality and to market conditions. The interest rate is normally a spread over LIBOR, although other bases may be employed, or the rate may be adjusted periodically.

Influence of 1984 Tax Legislation

In July, 1984, federal income-tax legislation was enacted that contained a major provision repealing the previously effective 30 percent withholding tax on interest payments to foreign investors. Table 5 indicates how the passage of this law (The Tax Reform Act of 1984) influenced the execution and the cost of Euromarket borrowings among the survey participants who commented on this point.

Prior to enactment of the 1984 legislation, it was necessary to issue dollar obligations abroad indirectly to circumvent withholding requirements. Some large companies established financing subsidiaries, many of them in the Netherlands An-

Table 5: Impact of Tax Legislation on Euromarket Offerings

Effect	Number of Mentions
Facilitated accomplishment of issues	13
Lowered cost of issues	8
Negligible influence	7
Other	3
Total	31

tilles, to accomplish this end. But many smaller firms did not do so because they were unwilling to assume the financial and administrative burdens required to maintain such units. Now all U.S. companies enjoy direct access to the Euromarket with the concomitant benefits of quicker delivery and smoother implementation. "The removal of withholding tax requirements on foreign holders of domestic bonds," says the vice president and treasurer of a participating manufacturing company, "has essentially made transactions in the Eurodollar market easier to execute, with simpler documentation and, generally, less complexity."

Eight survey participants report that lower costs have resulted from repeal of the withholding requirement. But this benefit flows not so much from lower interest rates obtained in foreign markets as it does from reduced administrative costs in connection with the financings. While some international issuers did get lower-cost coupons abroad in the months immediately following removal of withholding regulations, such rate advantages traced largely to special factors. These included soaring

demand for U.S.-dollar-denominated debt by foreign investors and the desire to demonstrate continued viability by foreign underwriters that were facing stiff competition from rivals in the United States. Recently, spreads have narrowed between domestic and Eurodollar rates and cost savings presently trace mostly to reductions in overhead in connection with international financings. However, the treasurer of a service company wonders if savings in administrative outlays result in net gains for domestic issuers in international markets:

"The removal of withholding tax requirements has made the execution of offerings in Europe significantly easier. This is because there is no need for a Netherlands Antilles corporation to eliminate withholding on foreign-held securities. It is questionable whether the cost of borrowing in the Euromarket has been reduced. Although some issuance costs were removed with the withholding tax change, the Euromarket has seen more and more offerings from U.S. issuers and the spread to the U.S. market has decreased. Consequently, although we may have reduced our issuance costs, the ability to obtain rates below those of the U.S. market in Europe has diminished as well."

Seven cooperating companies reported little, if any, effect from changes in withholding rules. This is because they have either not done any financing in the international markets since the passage of the legislation or they believe that the cost savings are inconsequential. Two companies mention that it has become necessary for them to provide foreign investors with indemnification against the possible reimposition of tax withholding during the life of issues. And one company indicates that the removal of withholding increases the likelihood of its launching an issue in the Euromarket.

Innovative International Financing Approaches

Innovation has been anything but a stranger to international financial markets. Much in the way of experimentation has taken place. Bankers have devised many new instruments to ease market access for clients.⁴ Two of the approaches they have pioneered, swaps and note issuance facilities, have come to the fore.

Swaps

Earlier in this decade, the term "swap" referred to a transaction in which a company exchanged its own common shares for its own outstanding bonds. The bonds were purchased in the marketplace by middlemen, usually investment bankers, at

substantial discounts from their par values because of sharp increases in interest rates during the time they were outstanding; then the bonds were swapped for comparable dollar amounts of common stock. The net result: Companies retired bonds at favorable prices while strengthening debt ratios, and investment bankers earned commissions and, in some cases, profits on the shares received when they ultimately sold them to other investors.

But times have changed, and so has the meaning of the word "swap." Nowadays, swaps come in several varieties and do not ordinarily relate to exchanges of shares of stock for bonds. Rather, they involve exchanges of interest rates, currencies—or both. Their role in international finance is growing in importance. Estimates indicate swaps played a part in 60 percent of 1985 international capital market issues.⁵

⁴For a discussion of recently employed techniques and instruments see "A Checklist of New Techniques," *Euromoney*, London, October 1985, and Henry Kaufman and Jeffrey Hanna, *Prospects for Financial Market in 1986*. New York: Salomon Brothers, Inc., 1985 pp. 34-39.

⁵James Sterngold, "Raiding of the Rate Swappers," *New York Times*, January 14, 1986.

Interest Rate Swaps

Interest-rate swaps ordinarily consist of the exchange between two counterparties, often with the assistance of a third party acting as an agent or temporary principal, of a floating rate of interest for a fixed rate of interest in the same currency for a specified term. But they may involve the exchange of floating rates of interest computed on different bases—prime rate and LIBOR, for example. Either way, the transactions do not require any exchange of principal but only agreement to assume responsibility for the other party's interest payments.

At their inception, interest rate swaps usually involved foreign banks and domestic corporations with less than top quality credit standings. But participating parties have expanded to include a wide mix of corporate and financial institutions throughout the world.

Perhaps the greatest inducement for entering an interest rate swap is cost savings for both parties. How can each reduce interest outlays? Consider for purpose of illustration the case of international Bank X and lower-rated manufacturing Company Y. The former wants to secure floating-rate dollar financing; the latter, fixed-rate dollars. But expensive interest-rate structures in the respective markets make proceeding as indicated impractical. Instead, Company Y manages to borrow at a relatively favorable cost in the floating-rate market, and Bank X similarly borrows a like amount in the fixed-rate market. An agreement is reached between X and Y, whereby the respective interest liabilities are swapped, or exchanged. The bank, which had been the fixed-rate borrower, becomes the floating-rate payer, and vice versa. The net result: Company Y and Bank X each gets lower rates, perhaps 50 basis points or so, than if it had borrowed in its preferred markets directly. Company Y reaps the benefit of the interest saving accorded the higher-rated Bank X. To induce the bank's participation in the swap, Company Y shares its savings with bank X by dropping the rate it has passed along. This reduction, while lowering Company Y's gain, enables Bank X to assume a repayment obligation lower than would have been the case had it borrowed directly in the floating-rate market.

Beside the benefit of cost savings, interest rate swaps offer other advantages. For one, they enable participants to reap profits (or cut losses) through the mechanism of swap reversals, if interest rates swing in the opposite direction. For another, they enable companies effectively to utilize markets that might not otherwise be available to them, and to do so quickly since clearance, reporting and disclosure requirements are minimal. Still another benefit is that they provide flexibility by permitting companies to stretch out the effective maturity of short-term borrowings—commercial paper obligations, for example.⁶

Currency Swaps

Currency swaps in their most uncomplicated form have three elements: (1) an initial exchange of principal amounts of two currencies; (2) an ongoing exchange of interest payments at

⁶For illustrative examples, see Tanya S. Arnold, "How to do interest rate swaps," *Harvard Business Review*, September-October, 1984, pp. 96-101.

agreed upon fixed rates during the term of the agreement; and (3) a reexchange of principal amounts at maturity. For example, Counterparty A might swap the proceeds of a Swiss franc denominated bond issue with Counterparty B for U.S. dollars to launch an arrangement. Then, at intervals, during the course of the swap agreement, each counterparty makes interest payments for the other in accordance with preset fixed rates. Finally, to conclude the swap, the counterparties reexchange the principal amounts traded initially.

These arrangements had their genesis in the 1960's when, companies would arrange back-to-back loans with each other in order to circumvent foreign-exchange controls and secure desired currencies. For example, a foreign company would lend local currency to the subsidiary of a U.S. company located in its country while, simultaneously, the U.S. parent would lend an equivalent amount in dollars to the foreign company's subsidiary in the United States. Currency swaps simplified the process in many instances.

Fixed-rate currency swaps resemble foreign-exchange contracts but provide greater flexibility, by permitting the fine tuning of maturities and amounts, for example.⁷ Like interest rate swaps, currency swaps offer counterparties opportunities for savings by allowing them to take advantage of special opportunities in particular markets. Of course, they also permit companies to obtain currencies that might otherwise be either more difficult or expensive to secure.

Combinations

Combined interest rate and currency swaps, known also as currency coupon swaps, cross-currency interest rate swaps and circuses, include the features contained in both types of swaps. A circus, consists of the swaps of principal amounts of two currencies at a specified exchange rate, the exchange of floating rate interest payments in one currency for fixed rate interest payments in another currency, and the reswapping of principal amounts at maturity.

These combination swaps, though somewhat complex, find a variety of useful applications—in foreign leasing transactions, for example. And they offer many of the advantages held forth by their component swaps, including cost savings.

Application and Arrangement

Twenty-three participating companies have used swaps in connection with recent international financings. Ten entered interest-rate swaps; eight, currency swaps; and five, combinations of the two. Five other companies have swap arrangements of one kind or another under active consideration.

The fourteen concerns commenting on the arrangement of swap transactions indicate they paid fees to financial institutions—six investment banking firms, four commercial banks, and four lead managers—to arrange deals with counterparties and, in some cases, to guarantee performance of the

⁷For detailed discussion of foreign-exchange transactions, see Roger M. Kubarych, *Foreign Exchange Markets in the United States*, Federal Reserve Bank of New York, 1978.

counterparties. Finding other organizations with interest rate or currency needs that can be filled with a swap is no easy task for companies engaged in manufacturing, service or other commercial activities. Indeed, it is sometimes a difficult undertaking even for institutions specializing in the arrangement of financings. However, when counterparties are not readily available, certain of these arrangers take swaps into their own inventories, at least temporarily, by acting as principals rather than brokers.

Views on Use

Most participating companies, whether or not they currently employ swaps, are keenly interested in their emergence, viewing them as additional instruments in the hands of financial managers. Some see them as effective means of managing liabilities; others, as instruments for arbitraging markets and hedging assets; and, still others, as ways of overcoming constraints in entering international markets.

But participants also warn that swaps, though useful, are not without risk: namely, the possible failure of a counterparty to fulfill its side of the transaction. Fear of such an event has caused one participating company, an active user of international markets, to shun all swaps to date. It believes assuming an inferior credit risk would more than offset any rate or other advantage gained through swapping.

However, avoidance of unwanted exposures is only one of the reasons advanced for not engaging in swaps. Keeping away from the taxing requirement of engaging in a lengthy series of possibly market-disrupting swaps if the amounts involved are very large is also mentioned. So is the ability to gain access to fixed- and floating-rate markets competitively in a direct manner.

One participating utility company willingly enters currency swaps, but takes pains to avoid interest-rate swaps. By way of explanation, a spokesman notes that utilities are required to project interest-rate costs to secure rate increases from regulatory commissions. And commissions tend to come up with lower estimates of floating-rate debt costs than does the company. To avoid disputes in rate hearings, the utility opts for fixed-rate borrowings and steers clear of swaps to floating-rate debt, even though such swaps are potential expense reducers.

Here are some typical comments by respondents on the use of swaps:

"We view the use of swaps as a good tool for asset and liability management. Since the swap market has become much more efficient, good arbitrage opportunities are no longer prevalent, but swaps do provide the ability to adjust duration and cut rate sensitivity on our portfolios."

Vice president and treasurer, a financial institution

"We view the use of swaps as providing additional flexibility to obtain the lowest cost financing, rearrange maturities of existing borrowings, change the corporation's foreign currency exposures, and avoid the time-consuming and burdensome requirements of some foreign authorities."

Executive vice president, a manufacturing company

"We view the use of swaps, both currency and interest rate, as providing important flexibility for our corporate financing activities—certainly allowing greater access to world capital markets than was previously possible."

Vice president and treasurer, a manufacturing company

Note Issuance Facilities

Also known as revolving underwriting facilities (RUF's), note issuance facilities (NIF's) are arrangements that give borrowers long-term access to short-term money. Organized in a variety of ways, the note-issuance facility has, since its recent introduction, won a growing number of adherents among governments, financial institutions and corporations.

Just what is a note-issuance facility and how does one work? The following concise description from a recently published study provides the answer:

"A note issuance facility is a generic term for a syndicated financing arrangement that guarantees an issuer access to a certain amount of funds for a prescribed length of time. At any time during the term of the facility, the borrower may request that a portion of the facility be drawn down, which results in an offering of short-term securities. These negotiable instruments are evidenced by promissory notes and are usually brought to the market for periods of one, three or six months. At the end of each interest period, notes may be repaid or offered in a new tranche. Notes are offered through a sole dealership or an auction mechanism to short-term investors. If an issuer's full request is not purchased by these investors, the notes are sold to a group of underwriting banks who commit, in advance, to purchase the notes at a predetermined spread, which is generally relative to LIBOR. Alternatively, these underwriting banks may provide funds through a separate lending arrangement. Underwriting commitments can run as long as 15 years, with the usual maturity in the five-to-seven-year maturity range."

These facilities are often designed to meet the unique requirements of individual issuers and so differ from one another in certain respects. While many with NIF's or RUF's enjoy top credit ratings, some lesser rated companies employ versions of them under which they issue grantor-underwritten notes.

Rationale for Establishing NIF's

These facilities, which often go undrawn, offer issuers several advantages. They sometimes serve as inexpensive backups for commercial paper. Note-issuance facilities also provide less expensive financing than other borrowings—floating-rate note issues, for example—because of inherent drawdown and timing rights. Notes under facilities can be issued at opportune times—perhaps at a point when rates have declined—whereas rates on floating-rate notes are usually set at predetermined intervals regardless of market conditions. And note-issuance facilities can be custom-made to meet the special demands of individual issuers.

"Gioia M. Parente, Introduction to the Note Issuance Facility," Salomon Brothers Inc., March 1985, p. 1.

Several participating companies have near-term plans to launch NIF's or RUF's facilities. One, a retailer, recently did so because the revolving underwriting facility "complements and is consistent with the corporate strategy of diversifying capital procurement." Its chief financial officer sees the RUF providing the firm with several benefits: favorable positioning in the early stages of a new market, possible access to less than LIBOR rates on medium-term floating-rate borrowings, desirable exposure to new financing sources including international banks, and reductions in certain borrowing-related costs, especially those for rating and listing.

Roadblocks to International Financings

While some participating companies maintain that no serious obstacles stand in the way of using international markets, others disagree. Roadblocks, where perceived, relate more to foreign domestic capital markets than to the Euromarket. (See Table 6.)

Travel encumbrances, communication snags and procedural hitches that occasionally arise in connection with foreign financings annoy some respondents. For, the most part these are considered irritations, however, not dangerous obstructions barring access to international markets.

Foreign governments' rules and regulations, especially those controlling foreign exchange, are seen as impediments to foreign financings by some survey participants. Others view the incomplete development or insufficient depth in certain foreign markets in a similar vein, since these deficiencies sharply limit issue size. Still others consider the queuing systems imposed in some foreign countries as serious constraints that require issuers to await turns to offer securities packages.

While some respondents think the documentation of international financings is less complicated than that for domestic deals, not all share this persuasion. Dissenters believe paperwork problems associated with foreign borrowings cause delays and are expensive. Describing them as "maddening," an interviewed international financial executive claims documentation troubles often arise from legal hassles pitting opposing counsel in battles of words not easily resolved because prototype agreements are seldom available. Development of standard forms to document financial arrangements that involve different parties, currencies, lawyers and managements, would, in the view of some, go far toward resolving this difficulty.

Other, seldom-mentioned obstacles in the path of international financings include capacity limitations in certain currency-swap markets, and potential refunding problems for issuers because of the bearer nature of debt. The need to instruct top management on the merits of various international

Table 6: Obstacles to Use of International Markets

<i>Obstacles</i>	<i>Number of Mentions</i>
Minor nuisances (e.g., travel and communication difficulties)	14
Government restrictions	7
Capacity limitations	6
Queuing requirements	5
Documentation problems	4
Other (e.g.,)	4
Total	40

financing proposals is also cited. In the time required to convince decision makers to proceed, windows may close and opportunities evaporate.

Some typical perspectives on hindrances to financing in international markets follow:

"The quickened pace of worldwide financial deregulation has enabled the company to expand its presence and participation in foreign financial markets. The notable exception to this trend would be the company's consideration of a Euroyen or Samurai offering, both of which are currently prohibited by the Japanese Ministry of Finance."

Senior vice president, a financial institution

"The Euromarket continues to evolve and is competitive as a source of intermediate term funds. Foreign domestic capital markets vary considerably. In many countries where we have a need for funds, the capital markets are either nonexistent or not very well developed."

Corporate vice president and treasurer, a utility

"There are no serious obstacles in using the Euromarket; however, higher levels of documentation and queuing systems limit access to foreign domestic markets in Japan, Germany, Switzerland and France."

Senior vice president, a manufacturing company

"We see no obstacles that currently limit our use of the Euromarket. With regard to foreign domestic capital markets, obstacles include limited size of possible financings, limitations imposed by some national authorities on the use of proceeds, the queue system imposed by the national authorities of some countries, and burdensome documentary requirements in some markets compared with the relative simplicity of swap documentation."

Executive vice president, a manufacturing company

Supplementary Readings

Much has been written about international financing in its various aspects in textbooks, special studies and the business press. A sampling, for readers wishing to obtain further background, follows:

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Roger M. Kubarych, *Foreign Exchange Markets in the United States*, New York: Federal Reserve Bank of New York, 1978.

Alan F. Snider and Michael J. Collins, *A Guide to Currency and Interest Rate Swaps*, Philadelphia: Robert Morris Associates, 1985.

Henry Kaufman and Jeffrey Hanna, *Prospects for Financial Markets in 1986*, New York: Salomon Brothers Inc., December 1985.

Ellen Pearlman, "A guide to the Japanese market," *Institutional Investor*, May 1983.

David Shirreff, "The Euronote Explosion," *Euromoney*, December 1984.

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Keith Wishon and Lorin S. Chevalier, "Interest Rate Swaps—Your Rate Or Mine," *Journal of Accountancy*, September 1985.

Research
Bulletin

No. 199

The Conference Board
70th Anniversary

R4105-29.66 F(A)

7/86

The 1986-87 Outlook: New Vigor for the U.S. Business Cycle

Summary of a meeting of
The Conference Board Economic Forum

Management Summary

- The Forum consensus adds up to a surprisingly favorable outlook, with economic activity expected to rise at a sturdy $3\frac{1}{2}$ percent pace well into—perhaps through—1987.
- The energizing forces include lower energy costs, lower interest rates, and the “wealth effect” of higher equity prices. These favorable factors are operating in most of the industrial countries, so the good news is not just local but global.
- Not every sector of the U.S. economy is participating; notable exceptions are the oil patch, agriculture and capital spending.
- Although inflation and interest rates will firm noticeably, in the absence of any overheating both should stay within reasonable bounds.

Economic and Policy Analysis Program

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May 7, 1986

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Tenacious Optimism—With Wild Cards

Edgar R. Fiedler

In contrast to many current stories about the economy, members of The Conference Board Economic Forum find themselves to be unusually optimistic and harmonious about the outlook for business into 1987. To be sure, the optimism is qualified in several respects: The rejuvenation of the cyclical expansion has not arrived yet. The capital goods, energy and agriculture sectors of the economy are not expected to join in the improvement. And there are several "wild cards" in the offing that must be surmounted.

Even with these qualifications, the Forum was tenaciously optimistic—and as confident as veteran practitioners of the treacherous forecasting game are ever likely to be. The group looks for the business-cycle acceleration to show up in the summer months, and to continue into—perhaps through—1987. And we expect the reinvigoration to avoid anything more than mild inflation and interest-rate pressures. (See table of projections, top of page 4.)

This favorable prospect extends to most of the world. Lawrence Veit, our international specialist, labelled his outlook "Global Good News." He compared the present situation to a football team that is given five downs per series instead of the usual four—a change that would dramatically raise the team's chances of victory. One of the new factors is the drop in oil prices, which is redistributing an enormous amount of purchasing power from OPEC to most of the industrial world, and thus from savers to spenders. A second is the realignment of exchange rates, which are now far less disruptive to normal commercial transactions than a year or two ago. This change is, of course, especially beneficial to the competitive position of U.S. manufacturers and farmers.

The third favorable factor is the worldwide decline in interest rates with its stimulative impact on housing and other interest-sensitive sectors. The next is a group of disinflationary forces—in addition to the drop in oil prices and interest rates—including keen international competition, major corporate cost-cutting programs, and labor's willingness to cooperate in raising productivity and restraining wage demands. Finally, there is the presence now in many countries of pragmatic governments working toward smaller deficits, reduced government spending, deregulation and international cooperation.

To this impressive list, other Forum members added a variety of recent developments favorable to the U.S. economy. Albert Sommers mentioned generally comfortable consumer attitudes and the absence, except for automobiles, of an inventory overhang. He and several others noted the "wealth effect" of the stock market rise—the prospect that higher equity prices will increase consumer spending. Econometric studies tell us that this effect is not overwhelming, but with the real net worth of households up \$600 billion over the past six months, it has to add up to a meaningful uplift for demand.

The Risks. In counterpoint to all these positive forces, a number of "wild cards" were mentioned—not wild cards in



Edgar R. Fiedler

Overall, a reassuring outlook.

the sense of a junior-high-school poker game (all twos, fours and one-eyes wild) but in the sense of offsets to the optimistic factors and uncertainties that deepen the murkiness inherent in any assessment of the outlook. The most immediate uncertainty is why the prospective strengthening of the upswing is not yet at least partly visible in the current statistics. Looking ahead, no one sees the well-publicized troubles in the oil patch disappearing anytime soon. In agriculture, the declines in interest rates and the dollar have relieved some of the distress, but have not yet sparked a recovery. The lower dollar should boost foreign demand for grains and soybeans, but with so much new crop capacity in place around the world the improvement is likely to be very limited. The business cycle is in a mature phase, now half way through the fourth year of expansion, which attests to an absence of any unsatisfied pent-up demand for consumer durables and capital goods—demand of the kind that typically fuels vigorous growth in the early stages of cyclical recovery.

Indeed, the outlook for business investment spending has turned sour. This prospect reflects the substantial underutilization of productive capacity throughout manufacturing, the dramatic shakeout in oil, the overbuilding of office and commercial construction, and the first major cutback in demand for high-technology equipment. Direct investment by foreigners is expected to offset some of the shortfall, but only gradually. Thus, Stephen Roach anticipates a 3-percent drop in real capital outlays over the course of 1986.

Another signal of cyclical maturity is the elevation of the consumer-debt burden, which now appears to be a bit weighty. Several measures of credit delinquency have climbed to uneasy levels. Finally, although most of the group feels the U.S. international trade imbalance will soon start to recede, the change may come slowly. As in agriculture, the drop in the dollar has improved the U.S. position substantially, but Milton Hudson reported that many business executives feel exchange rates have not yet moved to anywhere near what is needed to make U.S. manufacturers competitively whole in world markets.

Other wild cards are to be found in the area of economic policy. The group is divided and unsure about the thrust of

THE FORUM CONSENSUS
Results of a Pre-Meeting Outlook Survey

	Latest <u>Actual</u> 1985-1986	Projections			
		1986 IV85 - IV86		1987 IV86 - IV87	
		<u>Avg</u>	<u>Range</u>	<u>Avg</u>	<u>Range</u>
Economic Growth (Real GNP, percent change)	2.0	3.3	2.8-4.0	3.5	1.0-5.0
Inflation Rate (GNP Deflator, percent change)	3.0	2.7	2.0-3.2	4.0	3.0-5.0
	<u>IV84-IV85</u>				
Corporate Profits (After taxes, percent change)	4.3	7	0-15	5	-3-15
	<u>April</u>		<u>December</u>		<u>December</u>
Unemployment Rate (Percent)	7.1	6.8	6.6-7.4	6.7	6.4-7.5
	<u>Current</u>				
Commercial Bank Prime Rate (Percent)	8.5	8.75	7.25-10.5	9.25	7.75-12

Note: These forecasts were submitted by Forum participants in early May and are based on data available at the time.

Federal Reserve policy: Is it stimulative as suggested by the rapid growth of money (narrowly defined), by the drop in interest rates, and by the strength in housing? Or is it restrictive as suggested by the broader monetary aggregates and by the sluggishness in manufacturing? On the fiscal side, there are additional doubts, especially about the Gramm-Rudman-Hollings legislation and the efforts to revise the income-tax structure. First, if major tax reform is enacted, the pattern by which the changes are phased in will probably produce a half year of significant fiscal restraint. Second, despite the corporate rate cut, the prospective demise of the investment tax credit—a concrete, tangible, upfront subsidy to capital spending—is wreaking havoc with corporate rate-of-return calculations.

On the budget, most of us anticipate a reduction in the deficit from this fiscal year to next—in Lawrence Kudlow's calculations from \$222 billion to \$186 billion—but also find great obscurity about how much follow through is likely thereafter. Economic questions no longer dominate Washington politics as they once did. Issues such as terrorism, nuclear safety, runaway fathers, welfare and workfare now get more attention—but in a rapidly shifting and unpredictable pattern. As a result, both the public and the politicians are treading water, and the pressures exerted to curb the deficit have eased substantially. Until both the budget and tax issues get sorted out, the uncertainty is going to put a damper on business planning.

The Financial Environment. The discussion of inflation produced even less disagreement than the business cycle.

Thanks to energy, the consumer price index will rise only about 2 percent this year. But the oil price drop is a nonrecurring event and, once the direct effects work their way through the system, the inflation rate seems almost sure to accelerate again. If the recent numbers for the consumer price index are recalculated after removing oil and food, the "core" rate of inflation is currently continuing at a 4-percent rate, which is the consensus projection of the Forum for 1987. Some analysts have suggested faster inflation ahead from price hikes on imported goods and on the domestically produced goods they compete with. According to Joel Popkin, however, the 1985-1986 dollar decline will not boost U.S. inflation as much as the earlier climb in the dollar curbed our inflation. The reason is the more-than-ample availability of both raw materials and manufacturing capacity worldwide, which will keep competition intense and prices in check everywhere. Unless the dollar declines a lot farther, therefore, inflation does not appear likely to accelerate to troublesome rates anytime soon.

In the credit markets, Kenneth Wright interprets the recent sharp drop in interest rates as more a consequence of changed market psychology than of Federal Reserve policy. Currently, the market is reevaluating its previously highly favorable assessment of Gramm-Rudman, inflation, and Fed policy. Perhaps these sources of eased credit pressures are not as powerful and lasting as they initially appeared to be. By the final three or four months of this year, Wright feels, the strengthening of both economic activity and inflation will lead to a firming trend in market interest rates. Such a prospect seems consistent with Don Conlan's stock market outlook,

which calls for equity prices to be a bit spongy through 1987. Beyond that point, however, Conlan sees the equity markets as "very promising."

Summing Up. On balance, the economic positives clearly outweigh the negatives. Indeed, it is difficult to remember when so many significant expansionary forces were operating at the same time in so many countries. As a result, what earlier appeared to be a humdrum economic outlook has been transformed into a considerably brighter picture for some time ahead. The improvement has not arrived yet, but keep the faith, friends, it is on the way.

Some differences of opinion emerged among Forum members over the staying power of the U.S. expansion later in 1987, but these were differences not about direction but about the pace of growth: Would the expansion continue to be brisk or would cyclical fatigue slow it down? But overall, the outlook is reassuring. Unless Murphy's law takes over and the wild cards all prove especially damaging, 1986 and 1987 are likely to be years of simultaneous business-cycle expansion worldwide—not an explosive boom, but a solid steady advance. And without any overheating, inflation and interest rates should stay within reasonable bounds.

An Uncomfortable Bet on a Better Second Half

Albert T. Sommers

In the presence of a lot of confusion, reflecting frequent revisions and now a very improbable set of national-income accounts for the first quarter of 1986, optimism still prevails among forecasters for the second half of 1986 and for all of 1987. The optimism has strong and plausible roots in the economic policies that are being applied to the system, but most of these roots have been present for a considerable period of time, and the absence of a flowering into real growth is cautionary. The system gives the impression of being engaged in a tug of war, with extremely powerful pulls toward expansion on the one hand, and very heavy inertia on the other.

Growth in the first quarter appears to have been significantly less than the 3.2 percent carried in the preliminary national accounts release, and no acceleration is visible thus far in the second quarter. Yet none of the typical signs of impending ordinary recession are present: Inventories have been conservatively managed; the national-accounts estimate of rapid growth of inventory in the first quarter look a little exaggerated, even granting that the price valuation of inventory would have been negative; outside of commercial construction and office equipment, capital goods demand has certainly not been excessive in relation to markets; no "fiscal drag" is yet visible in the federal budget; interest rates are not rising in response to a rising inflation rate; the positive attitudes of consumers and businessmen have recently been strengthening.

On the other hand, there is no real sense of cyclical growth; no reason to expect a burst of consumer spending, or of inventory demand. Capital goods orders have been moderate to weak; only the housing market appears to be in condition for a spurt of growth. The system gives the impression that the connecting pins that convey a cumulative business cycle from sector to sector have been pulled out; cumulation, either upward or downward, has not been visible in the system for two years.

This pattern of slow and tentative growth occurs in the

Albert T. Sommers

The optimism has strong and plausible roots.



presence of a degree of policy stimulus that would certainly have driven the system to full employment and on into inflation a decade ago. The budget deficit continues at a \$200-billion rate; credit remains immensely available, at substantially lower rates than six months ago; the dollar has declined heavily against many relevant currencies, and most spectacularly against the yen — perhaps the most relevant currency of all. Securities markets delivered something like \$100 billion a month in realized and unrealized capital gains in the six months from September to February. A borrowing frenzy has appeared in capital markets; in the fourth quarter, funds were taken down at an annual rate of \$1.3 trillion. It is fair to ask why the response to all this has been so reluctant.

A first set of conditions — local, regional, but not necessarily temporary — would include the special recessionary conditions affecting parts of the system: agriculture, heavy industry engaged in the provision of basic capital stock, and, of course, the immense disruption of the petroleum industry. Private commercial construction (and, perhaps, up ahead public heavy construction as well) might be added to the list of sectoral casualties.

But other more fundamental considerations remain. The

two years of a quiescent growth rate have been years of disinflation, which affects incomes as well as prices. Growth in compensation has been slow; capital gains in the real world (that is, the nonfinancial world) have dwindled; personal interest incomes, which are equal to the entire payroll of manufacturing industries, have stopped rising. Because of these income effects, disinflation in the presence of high debt burdens is certainly, one would think, a constraint against rapid growth of demand. Aggregate debt has continued to grow rapidly nevertheless, but without swelling real incomes and debt-carrying capacity.

And the U.S. trade position doubtless belongs on a list of longer-term restraints. The outside world is still supplying about 25 percent of all U.S. goods markets, despite a fourteen-month decline in the dollar. The trade position is still suffering from the lagged effects of a very high dollar in 1983 and 1984, which encouraged the establishment of sourcing arrangements abroad, and even of building capacity abroad to serve the domestic market. These may be temporary and reversible consequences, but the time required (and the level of the dollar required) to reverse them may still call for years of adjust-

ment. The continuing high import propensity in the system tends to drain the stimulus originating in any part of it, and undoubtedly represents a major reason why such powerful policies have produced such modest results.

Despite the litany of problems, it would be surprising (and very unnerving) if the stimulus provided by present policies, and most particularly the decline thus far in interest rates, should not produce better economic performance in the last half of 1986, and this remains my own uncomfortable bet. But I do not think the moderate revival my model expects for the last half of 1986 should be carried through 1987. In that year, the United States will almost certainly confront the necessity of reducing the stimulative power of policy; the budget deficit should enter on a slow reduction, and the liberality of monetary policy will be constrained by a revival of price strength, attributable in part to the fallen value of the dollar. The U.S. consumption rate is too high for its present competitiveness in the world market, and its saving and investment rates are too low. Really vigorous economic performance will have to await a considerable and, in some degree, painful readjustment in these conditions.

Oil, Grambo and the Deficit

Lawrence A. Kudlow

The near-term negative impact on the 1986 Federal budget deficit is being forgotten in the euphoria over lower oil prices. The larger-than-expected Treasury refunding announcement supports the view that this year's deficit will reach \$222 billion, \$14 billion higher than the CBO estimate of \$208, and \$19 billion above the OMB projection of \$203 billion.

In the short run, the 50 percent drop in oil prices is depressing both inflation and real GNP growth. This means that the level of nominal GNP in FY 1986 (October 1985 - September 1986) will come in below the government's budget assumption. And lower money GNP means reduced tax revenues and a larger deficit.¹

There is no question that the positive oil shock will, over time, stimulate economic growth, hold down inflation, and keep interest rates lower than would otherwise be the case. All this will reduce the budget gap in 1987 and beyond. However, the trick is getting from here to there.

Economic Assumptions

In reports published last February, the CBO and Administration economic assumptions for 1986 (fourth quarter to fourth quarter) were quite similar: 4 percent real GNP; 3.5 percent CPI; 8 percent nominal GNP; 7 percent T-bill note; and, 9 percent Treasury bond rate. In recent quarters, both infla-

tion and real output appear to be coming in lower than budgeted. Nominal GNP in FY 1986 is now projected to rise by 4.7 percent, not the 6.5 percent estimated by CBO. This leaves a shortfall of \$56 billion in national income, roughly translating into a \$16 billion loss in revenues.

Other factors will also significantly affect the 1986 deficit. Defense spending is running ahead of estimates made last February. Lower oil prices reduce revenues from the windfall profits tax and reduce leasing activity from the intercontinental shelf. Falling interest rates reduce net interest expense, though most of this positive deficit effect will not show until FY 1987. Finally, the delayed 1986 budget reconciliation (COBRA) low-



Lawrence A. Kudlow

The 1987 deficit could fall to about \$128 billion!

ers the deficit through a combination of spending and revenue measures.

Changes in CBO Baseline Projection for FY 1986 (in billion \$)

February 1986 Baseline Deficit	- 208
Revenues	- 16
Defense	- 5
Interest expense	+ 3
Oil prices	- 3
COBRA	+ 7
Net deficit change	- 14
Revised 1986 Baseline Deficit	- 222

The lower level of FY 1986 GNP also affects the 1987 deficit. If nominal GNP rises next fiscal year by the budget's current 7 1/2 percent assumption, then revenues will fall short by about \$16 billion. About \$11 billion of this shortfall will be offset by lower interest rates, assuming market rates somewhere near present levels. This combination would raise the 1987 deficit estimate from \$181 billion to \$186 billion. Consequently, the "excess deficit" necessary to meet Gramm-Rudman-Hollings' (Grambo) target would be \$42 billion, with a \$32 billion excess above Grambo's \$155-billion upper boundary.

Supreme Court and Sequesters

Enormous uncertainty surrounds the Supreme Court decision, although some Washington experts have little doubt that the Supreme Court will uphold the lower court's narrow decision that the role of the Comptroller General to implement automatic across-the-board spending cuts is unconstitutional.

In that event, Grambo moves to plan B and a joint report by the Directors of CBO and OMB would be transmitted to a joint committee of the Congress, made up of the entire membership of the House and Senate Budget Committees. This committee will report the contents of the CBO/OMB sequestration report in the form of a joint resolution to be passed

by both Houses and approved by the President. If he signs, the sequestration would proceed.

Rather than another automatic trigger, Grambo B requires an up-or-down vote from the Congress. Of course, Congress could actually pass a budget resolution that meets next year's \$144-billion deficit target. However, unless the tax and appropriations committees actually reconcile the spending and revenue measures contained in the resolution, the \$144-billion deficit target will require a sequester. In recent years, budget resolutions have never been completely reconciled. The 1986 budget resolution of \$55 billion in deficit-reduction measures was finally reconciled with only \$7 billion in budget cuts and revenue increases.

Two other points are worth noting. First, it is possible that the Supreme Court will uphold Grambo. Some experts believe that the Comptroller General, with a 15-year term, is a creature of neither Congress nor the Executive Branch. Moreover, if the Court rules against Grambo, it might invite further lawsuits calling for the abrogation of other independent agencies, such as the Federal Reserve Board and the Securities and Exchange Commission. To avoid this, the Court might leave matters alone.

It is possible that the positive oil shock might sufficiently "energize" next year's economy to produce 5-6 percent real GNP growth, with only 3 percent inflation. This outcome would bring the level of FY 1987 nominal GNP back to the budget assumptions. So the \$16-billion revenue loss would be made up, and the baseline deficit would come in around \$170 billion, only \$26 billion above Grambo's target. If Congress or the Supreme Court mandates a \$42-billion sequester, and the oil factor works to increase growth and revenues, then the actual 1987 deficit could fall below Grambo's target to about \$128 billion! This would lower federal borrowing and ease credit-market pressures in calendar 1987 and 1988, and would hold interest rates below where they might otherwise be.

In turn, economic growth (and particularly investment) would be stronger, thereby generating still more revenues and an even lower deficit outlook. This "virtuous circle" created by Grambo and cheap oil, could be an unexpectedly positive wild card in the overall economic and financial outlook.

The Challenge to Monetary Policy

James Tobin

The economic recovery in the United States has been stalled for nearly two years, during which time the unemployment rate has been 7 percent, plus or minus tenths, and capacity utilization has been around 80 percent. The coast is clear for the Federal Reserve to stimulate an expansion that would lower unemployment another point, reduce excess capacity to more normal prosperity rates, and raise the path of real GNP 2 1/2 or 3 percent. It would take two years of 4 to 4 1/2 percent real growth to complete the recovery in this way. No bottlenecks, shortages, scarcities or signs of inflationary pressure stand in the way. Should they appear en route, the Fed could slow the expansion.

The Fed's immediate challenge is the currently evident weakness of aggregate demand. To prevent a 1986 recession and to resume the long-stalled recovery probably will require further reductions in short-term interest rates. If these are coordinated with interest-rate declines in Europe and Japan, the world economy will benefit and the United States will gain from additional export demand. Fiscal support of domestic U.S. demand is already decreasing. The structural budget deficit is declining, and will fall even more sharply if Gramm-Rudman targets are met. We are well on the way to the correction of the monetary-fiscal mix that has long been needed, and the Fed must play its part in this correction.

There are, it is true, powerful positive demand forces in the offing. The depreciation of the dollar will improve net exports after the J-curve effects, from which we now suffer, are reversed. The spectacular decline in the long-short interest premium will gradually stimulate residential construction, and



James Tobin

The Fed must play its part.

the decline in the cost of capital to business will help plant and equipment investment, which now appears to lag because of uncertainties about tax "reform" and because of excess capacity and the sluggishness of the economy. The decline in oil prices will stimulate consumption, eventually more than offsetting the negative effects on investment by the domestic oil industry. While these events might justify caution in monetary policy in 1987, or even late in 1986, they need not inhibit expansionary policy now.

Nor is there any reason for the Fed to "defend" the dollar from further decline by raising U.S. interest rates. Better, of course, to have foreign rates go down. But, in any case, it is likely that any further fall in the dollar would be arrested by expectations of its subsequent rise, without any rise in U.S. interest rates, which would be unjustified by domestic macroeconomic conditions.

Global Good News

Lawrence A. Veit

It is strange that so many observers now overlook the extraordinarily positive direction of world economic and financial developments. For most nations, real GNP is rising materially; disinflation is pervasive, proceeding in some countries to the point where consumer price indices are actually falling; and balance-of-payments disequilibrium appears to be declining in the course of 1986-1987. (See table.) To be sure, unemployment is still excessive; the indebtedness of selected nations, companies and individuals is too high relative to income levels; protectionism remains a serious threat; and markets are more volatile than is healthy for sound decision making. But these difficulties all seem to be easing with time. Moreover, domestic political environments are now more favorable to private enterprise than in many years — helping profits to grow — and international cooperation also seems to be seeing a new lease on life. In retrospect, the once-in-a-lifetime rally that has infected many countries' stock and bond markets is no accident. It may not be reversed soon.

Five related forces lie behind this admittedly optimistic conclusion.

(1) The price of oil has fallen, redistributing purchasing power to those who are likely to favor spending over saving. Some nations and some economic sectors will feel severe pain as a consequence of lower oil prices but, because the current peri-

Lawrence A. Veit

The once-in-a-lifetime rally in stocks and bonds is no accident.



od is in many ways the reverse of the arduous 1973-1983 years, the losses will be more than compensated for by gains elsewhere. Even assuming that the average cost of oil will rise to \$18-\$20 a barrel by the end of 1986, the GNP stimulus and the disinflationary impacts of oil will add up to a big plus for the world economy.

(2) Exchange-rate relationships today are far less disruptive to the progress of normal commercial transactions than in February, 1985, when the U.S. dollar was greatly overvalued. This means that U.S. manufacturers have had their competi-

World Economy: 1985-1987

	Real GNP (% Change)			Consumer Prices (% Change)			Current Account Balance* (\$ Billions)		
	1985	1986	1987	1985	1986	1987	1985	1986	1987
OECD, total	2.8	3.3	3.7	4.8	3.5	4.3	-59.7	-14.0	-5.0
United States	2.2	2.7	3.8	3.6	2.5	4.4	-117.7	-104.0	-65.0
Other OECD	3.1	3.6	3.6	5.4	4.1	4.3	58.0	90.0	60.0
Japan	4.6	3.7	3.5	2.0	0.5	1.0	49.3	60.0	35.0
Canada	4.5	3.2	3.5	4.0	3.5	3.5	-1.9	-1.5	-1.0
Germany	2.4	3.8	3.5	2.2	0.0	1.0	13.1	19.0	12.0
France	1.3	2.6	3.0	5.8	3.5	3.5	0.3	2.0	1.0
United Kingdom	3.5	2.7	2.7	6.1	4.2	5.0	4.5	1.0	0.0
OPEC	2.5	2.5	4.0	9.5	8.0	8.0	-26.0	-30.0	-25.0
Non-OPEC LDCs	4.0	4.5	5.0	40.0	38.0	32.0	-25.0	-10.0	-15.0
Mexico	3.0	1.0	4.0	57.8	70.0	65.0	0.0	-2.5	-2.0
Brazil	8.0	6.5	6.0	274.2	145.0	50.0	0.0	0.5	-1.0
Other**	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	110.7	54.0	45.0

*Includes statistical discrepancy.

**Includes official transfers.

N.A. Not available.

tive positions restored to the point where they will now win larger shares of the U.S. and foreign markets — GNP will rise faster than domestic demand, and the merchandise-trade deficit will shrink. It also indicates that import prices abroad will be falling, increasing real purchasing power and thereby encouraging GNP growth to accelerate.

(3) Interest rates have declined sharply. In the first instance, this will encourage business investment and consumer spending, especially for durables. In addition, because interest is a major cost factor, lower rates may both spur profits and help curb price inflation. The indebted LDC's will also be major beneficiaries — in the case of Mexico and other oil exporters, lower rates will substantially mitigate the burden imposed by falling crude prices.

(4) All the above factors reinforce disinflationary tendencies. They are supported in this respect by (a) an increasingly keen international competition that features aggressive new exporters such as Korea, Brazil and India; (b) major corporate investment programs aimed at reducing costs; and (c) a new willingness of labor to compete by raising productivity and restraining wage demands. The progressive reduction in inflation rates due to these forces has given governments new opportunities to pursue expansionary policies without fear of reigniting double-digit inflation. Finally, if inflation is equated with uncertainty, the lower rates now prevailing are acting as a spur to investment and consumer spending.

(5) Pragmatic government policies in many countries now feature the reduction of budget deficits, lowering government spending as a share of GNP, privatization, deregulation, and international cooperation in such sensitive areas as interest-rate and foreign-exchange policy. Even though the results thus far leave much room for further progress, the change in direc-

tion — away from state intervention in the economy and an anti-entrepreneurial bias — is to be welcomed.

The foregoing analysis may appear euphoric against the background rhetoric of surrounding events such as the Tokyo meeting of Heads of State, congressional negotiations over budget reduction and tax reform, ongoing discussions with Mexico and other international debtors, differences between Europe and the United States regarding agriculture, and the OPEC meetings at which Saudi Arabia has confronted a number of its oil-producing allies with competition for shares of the world oil market. In fact, conflict is the essence of each of these negotiations and the ensuing friction may not be a serious threat to international prosperity. In recent years, particular instances of protectionist backsliding pale by comparison with the expansion of world trade. And, most important, the convergence of the major world economies and the new spirit of cooperation that emerged from the Group of Five meeting last September auger well for the world economy.

Prospects for further disinflation, real growth, and convergence appear even brighter in the wake of the recent Tokyo Summit. Dissatisfaction with anarchy in the foreign-exchange markets appears to have given way further to an official effort to prevent excessive volatility and aberrations in rates that distort commercial relationships. Consequently, exchange rates at the end of 1986 may be little changed from those now prevailing. It would be unrealistic to predict that the powerful stock and bond price surge of the past year will continue unabated. Nevertheless, it is now clearer than ever that the past rally has reflected improving economic fundamentals. It now remains to see whether the governments of leading countries can translate the lofty objectives of their leaders into the conditions for further economic prosperity.

Modestly Accelerating Inflation

Joel Popkin

Because of the decline in oil prices, the consumer price index (CPI) will increase about 2 percent during 1986, its smallest increase for any year since 1965. Largely as a result, wages are likely to rise a bit less than their 4.1 percent increase of last year.

But wage and price increases have slowed about as much as they are going to and should accelerate during the rest of 1986 and 1987. There are two reasons to expect prices to accelerate. First, the end of the drop in gasoline and fuel-oil prices will remove a major drag on increases in the CPI. Second, depreciation of the dollar has already put upward pressure on prices, and that pressure will continue. Wages will pick up due to the acceleration in the CPI, but with a lag.

The likely uninterrupted growth of the economy this year and next should be an additional source of upward thrust to wages and prices. The only threat to continued growth is the unlikely prospect that the deficit will be cut to current Gramm-Rudman-Hollings targets and the Federal Reserve Board will not act in a timely way to offset the resulting contractionary impact. But the far greater likelihood is that the United States will contribute to and benefit from worldwide economic expansion, which could make the pace of expansion faster than currently anticipated.

In 1973, the world experienced strong economic growth, spurred by the simultaneous expansion of the economies of the major industrialized countries. That prospect is possible during 1986-1987. The climate for such a development arises

Joel Popkin

Wage and price increases have slowed about as much as they are going to.



primarily from recent monetary and/or fiscal policy developments in West Germany, Japan and the United States and the unleashing of substantial purchasing power among users of petroleum products. But one element of the 1973 experience will be absent — surging inflation. Worldwide excess supply of agricultural, energy and other industrial commodities and of manufacturing capacity should preclude any *sharp* acceleration of inflation, here or elsewhere, for several years.

The prospect of higher inflation in 1987, plus healthy economic growth, should stop the slide in long-term interest rates. They are likely to drift upward over the next six months.

A Brighter Outlook for Consumption and Housing

Milton W. Hudson

The sharp decline in oil prices has set in motion a train of events that has very favorable implications for both consumption and housing. Most importantly, consumers have had a windfall increase in real purchasing power; interest-rate levels have fallen significantly; and consumer wealth — reflecting sharply higher prices for stocks and bonds — has risen sharply. This improvement in fundamentals has transformed what had been a fair outlook for consumption and housing into something considerably brighter.

That is not to say that household spending is now likely to rise explosively. That might well be the prospect if the oil-price decline and the events that have attended it had occurred at an early phase of general business-cycle expansion. But we are not in the early phase of an expansion, and the best judgment is that the spending response to recent favorable developments — while significant — will be much more muted. We think that new staying power has been imparted to household spending at a time when it otherwise might reasonably have been expected to weaken.

We are, after all, in the fourth year of general cyclical expansion, without there being present anything like the kind of unsatisfied pent-up demand for consumer goods and housing that accumulates during recession. Instead, we have been through several years of quite vigorous household acquisition, characterized by spending increases that have outpaced income increases. This has resulted in a considerable buildup of household indebtedness and a notable slippage of the personal saving rate, which is now down to an anemic reading of about 4 percent. In historical perspective, indebtedness is now very high relative to income. And the frequency of credit problems

Milton W. Hudson

No ambiguity about the strength of housing.



has been growing sufficiently fast to generate quite a bit of worried commentary by creditors. This does not seem a particularly fertile environment for a surge in consumer spending. Certainly, the potential is much less than it would be if the personal saving rate were above 6 percent, as it was when the present cyclical expansion first got under way.

Even so, on a fourth-quarter to fourth-quarter basis, our forecast is for real personal consumption spending to increase in 1986 by 3 1/2 percent. That would be moderately larger than 1985's rise in consumer spending, and it would represent very solid performance for the fourth year of cyclical expansion. (See accompanying table.) Given the seeming need for debt consolidation, we expect nondurable goods and services to benefit more from the recent improvement in fundamentals than big-ticket durables. Furniture and household appliances, to be sure, ought to register outsized sales increases this year

Consumer Sector

	Historical			Projected	
	1983	1984	1985	1986	1987
(percent change, fourth quarter to fourth quarter)					
Real Consumption	5.3	3.4	3.0	3.5	2.1
Durables	14.5	9.2	5.8	4.0	1.3
Nondurables	4.3	2.0	2.7	3.5	1.6
Services	3.7	2.8	2.4	3.3	2.8
Real disposable income	5.1	3.9	1.3	3.2	2.0
Consumer price index	3.3	4.1	3.5	1.4	3.9
(average rate, fourth quarter)					
Unemployment rate	8.5	7.2	7.0	6.9	6.8
(millions of units)					
Housing starts	1.7	1.7	1.7	2.0	1.9
Auto sales	9.2	10.4	11.0	10.9	10.8
Truck sales	2.7	3.5	4.0	3.8	3.7

because of the strong advance now under way in housing. But, after several years of high-level auto and van sales, we are not projecting any further increase in vehicle deliveries this year. That view is reinforced by the lackluster showing of auto markets so far this year. On a fourth-quarter to fourth-quarter basis, we are projecting a slowing in 1987 in all categories of consumer spending, mainly because we believe that cyclical fatigue will develop as 1987 progresses. In assessing risks to our forecast, we do recognize that consumer-sentiment readings remain strong and that The Conference Board's buying plans index jumped very sharply in April—with gains broadly diffused among components of the index. For the moment, we are dismissing that April reading as a statistical aberration, since corroborative signs are not evident in the marketplace. But we are mindful that if our projections for consumer spending over the next several quarters are in error, they are more likely to prove too low than too high.

There is no ambiguity at the moment about the trend of housing activity. It is very strong, fueled by the sharp decline that has occurred in mortgage rates and the related rise in housing affordability. Despite oil-related difficulties in the South,

we confidently expect a total of 2 million housing starts this year (which would be the highest total since 1978), and we are projecting almost the same number of starts in 1987. We are, of course, already at a 2-million rate for housing starts, and have been for several months. But that does not mean that the peak impact of housing on the general economy has already occurred. Completions follow starts by roughly half a year on average, which means that the direct bolstering effect of housing on GNP will continue for a considerable span ahead along with the indirect bolstering effects that arise from enlarged ordering and delivery of furniture, appliances and home furnishings.

Our anticipation that no significant backup will occur in interest rates generally and in mortgage rates, specifically, is critical to our favorable housing projections. From their cyclical peak of more than 14 1/2 percent in the Summer of 1984, interest rates on fixed-rate mortgages have fallen to the vicinity of 10 percent. We expect them to remain at that general level, thereby maintaining housing affordability for many buyers who had previously been effectively barred from the housing market.

A Very Weak Prognosis for Capital Spending

Stephen S. Roach

The capital spending outlook has taken a sudden turn for the worse. Business fixed investment (in real terms) declined at a 13 1/2 percent annual rate in the first quarter of this year — the sharpest drop in three years. Moreover, the near-term prognosis is grim. New orders for nondefense capital goods — an excellent barometer of pending deliveries of business equipment — fell at an 11.8 percent annual rate in the first quarter, after having been essentially unchanged in the final period of last year. Similarly, contracts for business plant construction — which provide a good forward look at business building activity — sagged appreciably in the first three months of this year. And, at the same time, the Federal Government's latest plant and equipment spending survey — conducted over the January to March interval — points to a 1 1/2 percent annualized drop in real spending over the second half of this year.

This abrupt weakening follows a capital spending rebound that was really quite extraordinary by past cyclical standards. Over the first two years of this expansion, real investment outlays cruised along at a 20 percent annualized clip — over twice the speed of the typical cyclical upturn. As the accompanying table illustrates, over that period investment gains were broadly based. Especially sharp increases were evident in purchases of motor vehicles and high-technology items. But capital spending growth then screeched to a standstill in 1985, and the bottom fell out in the first quarter of this year. What are the key factors behind this sudden turn of events?

Stephen S. Roach

A grim reminder of cyclical vulnerability.



Recent Investment Trends

	Average Annual Growth		
	1983-I to 1984-IV	1984-IV to 1986-I	1985-IV to 1986-I
Business Fixed Investment	20.4%	2.0%	-13.6%
Basic Industrial	17.2	4.6	5.1
High Technology	29.6	-3.5	-35.6
Energy	13.0	-2.3	-23.1
Transportation	33.3	-0.2	-16.3
Other	15.0	8.9	5.2

A major consideration is that the existing stock of productive capital is being underutilized at present. By this stage in

a business cycle, capacity utilization in manufacturing has typically risen above 83 percent; by contrast, the factory-sector operating rate has been declining since mid 1984, and is now on the verge of moving below 79 percent. Whatever the cause — import penetration or a weakening of domestic demand — ample margins of slack capacity are a clear signal that corporate America does not need to bring more capital onstream to satisfy the needs of an economy still mired in a growth recession.

Another key consideration is corporate profits. Earnings in the capital-intensive manufacturing sector have been under steady pressure for over a year and a half. By the end of last year, factory-sector profits (including the inventory-valuation adjustment) still remained 20 percent below their mid-1984 peak. Protracted earnings pressure certainly brings into question issues pertaining to both the affordability and funding of business-spending programs. Aside from these general macroeconomic considerations, there are several relatively specific factors behind the deteriorating investment picture:

- First, the *oil industry* — which accounted for 8 1/4 percent of capital outlays in 1985 — is going through a dramatic shakeout. Following the sudden collapse in oil prices, major petroleum companies have slashed their 1986 capital spending budgets by around 30 percent. And since the latest plant and equipment survey points to “only” an 8 percent decline in petroleum industry spending and since this industry’s investment share presently remains over one percentage point above its 15-year average, further energy-related adjustments underscore downside risks to the capital spending outlook.
- Second, *construction* overhangs have been apparent for some time in office and commercial building activity. Paradoxically, while nationwide vacancy rates for office buildings hit a record 16.5 percent in late 1985, office-building activity continued to ride the crest of an extraordinary cyclical upturn. Indeed, as of the first quarter of this year, such outlays re-

mained at a level 48 percent above their mid-1983 low. Plain and simple: Unless there is a slowing of construction spending in this area soon, the stage could be set for a sharp and sudden collapse.

- Third, business demand for *high-technology products* remains depressed. IBM appears to have experienced its first major product cycle disappointment, and businesses in general are starting to raise some fundamental questions about programs that have led to the indiscriminate acquisition of the latest in trendy technology items. Such skepticism ultimately is healthy, however, and hardly seems surprising in light of our research, which points to what has thus far been a generally disappointing productivity payback of high-tech spending.

- A final negative for the capital spending climate is *tax reform*. For well over a year, Congress and the Administration have toyed with the notion that a comprehensive overhaul of this nation’s tax system should include either eliminating or scaling back incentives such as the investment tax credit and depreciation writeoffs. Uncertainty as to the ultimate disposition of these tax-code provisions makes investment planning fraught with peril. Indeed, in this environment hurdle-rate calculations become problematic at best, and that potentially causes delays and outright cancellations of many capital spending projects.

All in all, there are dark clouds looming over the business capital spending outlook. Based largely on the factors enumerated above, we are looking for a decline of 3 percent in real business fixed investment from the fourth quarter of last year to year-end 1986, which translates into a 0.3 percent drop on a year-over-year basis. Such an anemic investment performance is virtually without precedent for an expansion year — the only exception occurring during the so-called “mini-recession” of the late 1960’s. Thus, this gloomy investment outlook should also serve as a grim reminder of the cyclical vulnerabilities still faced by the economy at large over the near term.

Credit Markets in Transition

Kenneth M. Wright

Conditions in the U.S. credit markets have undergone a remarkable change over the past six months, more dramatic in some respects than has been seen over a comparable period in recent memory. Long-term Treasury yields plunged more than three full percentage points, almost touching the 7-percent level, while Aa-rated utility yields declined more than 250 basis points to fall briefly below 9 percent in mid-April. Long-term tax exempts fared somewhat differently, moving lower in yield through early March until uncertainties over the effects of tax-reform legislation caused bond buyers to hold back. Since short-term rates fell by much less, only one percentage point or so, one result of the market realignment was a distinct flattening of the yield curve, reducing the spread between long- and short-term yields. By mid-April, market yields in many sectors of the credit market had fallen to levels not witnessed since late 1977 or 1978, when interest rates were rising rapidly — in contrast to their recent sharp retreat.

Causal factors behind the downward shift in market yields are not hard to identify. The Gramm-Rudman-Hollings legislation of last December brought a new optimism that sizable deficit reduction would actually occur, in contrast to the failed promises of earlier budget programs. Even with the constitutionality of the legislation in doubt, it was felt that Congress and the Administration had broken the long-standing impasse. Predictions of Federal Reserve easing became more frequent in November and December, and even though the markets had to wait until March for a half-point cut in the discount rate, trading psychology ran ahead of events and pushed down yields anyway. In early February, the larger-than-expected break in oil prices brought a fresh new outlook complete with forecasts of a close-to-zero inflation rate for the year, thereby justifying a further decline in nominal interest rates. Finally, foreign investors continued their active buying of U.S. Treasuries and corporates in spite of the decline in dollar exchange rates that had been fostered by the Group of Five agreement of late September.

Market response to this new atmosphere brought forth an upsurge in corporate bond issues, taking advantage of the lowest borrowing costs in many years. Gross new bond issues surged to a record \$44 billion in the first quarter — equal to the full year total of 1983 — and in early May the calendar of forthcoming corporate issues was running over 50 percent ahead of a year earlier. Even more impressive, however, was the return to fixed-rate financing, which was used in 87 percent of first-quarter corporate issues, along with a greater share of maturities of 20 years and over. The transformation to long-term, fixed-rate borrowing at the most favorable yields in almost eight years suggested a return to the “good old days” before the inflation surge and the credit-market disruptions that followed the second oil shock of 1978.

Special conditions prevailed in the municipals market, however, in the period under review. State and local government issues hastened to utilize advance refunding opportuni-



Kenneth M. Wright

A firming trend in interest rates.

ties in the closing months of 1985, before tax provisions changed the rules at year-end. The tax-exempt market was further clouded by the changing signals emerging from congressional proposals as to the taxability of certain types of issues, and new offerings sagged from their earlier highs. Tax-exempt yields moved lower for a time but then flattened and edged higher under a new threat from tax-reform proposals to subject municipal-bond income to federal taxes under a minimum-tax approach for high-bracket individuals. The volume of Treasury securities continued heavy, of course, with little abatement in the current federal deficit, but met with receptive markets in the face of domestic credit easing together with a substantial appetite from Japanese and European investors.

Credit markets presently are in the throes of a reevaluation of the fundamental assumptions on which the bond-market rally of recent months was based. Will the Gramm-Rudman-Hollings targets withstand the tests of constitutionality and the political pressures against both tax increases and spending cuts, or with elections coming up later this year, will we see only partial relief in fiscal 1987? Will the Federal Reserve pursue a path of further easing, perhaps with another cut in the discount rate, or will the monetary authorities feel that current rate levels and credit availability are sufficient to ensure a stronger pace of expansion for the balance of the year? Will the price of oil persist at recent lows or creep higher in coming weeks? And can we count on low inflation rates ahead, or will the lower dollar bring a new form of inflation as import prices begin to move up and push the indices higher? Finally, there have been signs that dollar securities have lost much of their appeal to foreign investors whose own currencies have risen against the dollar in recent months.

The new wave of doubts and uncertainties — some would say a return to sober reality — has already brought a halt to rising bond prices and an upward push in market yields. The potential for further downward moves in interest rates — based perhaps on weaker economic trends for the next few months — seems limited, in view of the substantial market adjustment that has already occurred. After all, the lower-dollar trend promises in due course to revive faltering export markets and to reduce import competition, with the latter factor bringing

along the unhappy corollary of more domestic inflation. And the lower level of interest rates should serve to sustain incentives to borrow and spend, not only for housing but also for business capital goods and consumer durables. The fundamentals are more firmly in place for a better pace of economic

expansion in the latter half of 1986, continuing into next year, and it would be highly unusual in the annals of economic history if the expected acceleration in economic activity did not produce a firming trend in market interest rates during the latter months of 1986.

The Equity Markets: Past Is Prologue. Or Is It?

Don R. Conlan

There are many weird and wonderful ways of looking at the equities markets besides those fundamental but not terribly useful building blocks that we economists feel obliged to use. Indeed, I've poked around with this stuff for enough years to convince me that economists probably shouldn't even try. I believe the best stock market forecasters are pretty darn close to psychic in their sense of timing. Economists need too many facts. The good market forecasters go by the feel.

I could talk for the next half hour about the two key elements that drive stock prices: profits and interest rates. The former *pushes* up stock prices and the latter, translated into price/earnings (P/E) ratios, *pulls* them up. But can you think of two statistics that are more difficult to forecast, that have larger error potentials, or on which we do a worse forecasting job? And even if we got them right, we'd be frustrated by the variable leads and lags between these factors and stock price movements; as a result, we'd probably be bankrupt before we were proven right. Having said all that, I proceed.

I start with a very short view and follow that with a couple of progressively longer views. Let me offer the following maxim: In the very near term, there probably is no special upside limit to stock prices, nor any particular downside limit to long-term interest rates, unless and until a credible case can be made of oil prices having found a solid bottom:

- Sharply declining oil prices thoroughly drown any concerns people might have about inflation, almost regardless of what may be happening to prices elsewhere in the economy. With no certainty about oil prices, it's simply impossible for anyone to get very exercised about inflation and, even if they do, there's no reason for anyone else to pay much attention. You would expect declining inflationary expectations to come right straight out of long-term interest rates and they have. Since P/E ratios are the reciprocal of some discount rate applied to the flow of earnings, falling long-term rates generate rising P/E ratios. Rising P/E ratios pull up stock prices with or without underlying support from earnings.

- The initial effects of falling oil prices are negative in that they hit the energy-related sector of the economy immediately while benefiting the rest of the economy only with a lag.

Don R. Conlan

Earnings momentum definitely has slowed.



At the same time, they create a new batch of credit difficulties in the energy sector. Both these effects tend to induce the Federal Reserve to stick to an accommodative monetary policy. Tight money and rising interest rates are anathema to stock prices. Reasonable assurance of continued rapid money growth occurs usually only once in the business cycle, in the nascent stages of recovery. On those rare occasions when the market can detect such signals twice in the cycle, the results in the stock market can be quite heady, as we have seen. While the investor might be concerned about the long-run inflationary implications of protracted high money growth, he is not likely to worry about it much so long as oil prices keep falling.

That's the essence of the short-term view and, if close to the mark, helps to explain why stock and bond prices have risen far beyond expectations in the past six months even though earnings momentum has been disappointing. What can we say about oil prices? It seems to me that until the problem of oversupply of oil has been resolved—and that solution lies with Saudi-Arabia—the case for \$10-15 per barrel as the bottom in oil prices is as yet unconvincing. Therefore, one cannot yet say that we have reached the limits of declining inflationary expectations nor that long-term interest rates have bottomed out. If not, then one cannot yet say that we have reached the limits on either stock or bond prices.

Now, let's take the intermediate view and look at the key

variables—profits and interest rates—and see where they might take the markets over the next 6 to 9 months. Earnings momentum definitely has slowed and I am having a terrible time getting a fix on the true path of profits this year. I started out last year with what was then a very conservative estimate for 1985 of \$17.25 for the S&P 500 composite. By the time the year was finished and the effects of all the restructuring and associated writeoffs were taken into account (they say the writeoffs amounted to \$1.30-1.80), actual earnings for that year slipped under \$15.00. That's the worst mistake I've made in the several years since I began using a simple but useful little model based on changes in real GNP, the deflator and exchange rates. Earlier this year, I thought I had it all figured out and had allowed for the writeoffs but the first quarter has been disappointing as well. Oddly, as of now my estimate for *this* calendar year turns out to be the same \$17.25. We'll see if it works any better this time.

Long-term Treasury bond rates are running about 7.50 percent but, as I implied in my short-run view, I don't think the decline in rates is over yet. The economy shows no evidence of breaking out of its 2 percent growth straitjacket; indeed, our analysts have been ragging me pretty hard lately about the validity of my projected second-half pickup. They aren't seeing it out in the field. Further, I see little opportunity for the Federal Reserve to tighten until the pickup happens and it is clear to all. While I don't expect long Treasuries to go below 7 percent, I do think they will go back to near that level again in the next few months. After that, assuming that money has not lost its powers of economic stimulation and assuming that oil prices do find a bottom in the next few months, I think it's reasonable to expect some rise in rates as we approach year-end.

Using \$17.25 for the S&P and the reciprocal of my expected low of say, 7.25 percent on the long Treasury as a proxy for the "appropriate" P/E ratio, (13.8X), the S&P is correctly priced at its present level of 235-240 but it's no bargain. It's no bargain because if I'm wrong on profits I probably have them too high and I can't expect another big drop in interest rates to bail me out. The market over the past 9 months has been pulled up by declining interest rates (and, consequently, rising P/E ratios). It certainly has not been pushed up by earnings growth! Thus, as soon as it becomes clear that interest rates have bottomed out, we will see a lot of attention paid to earnings potential. If the long-awaited second-half economic pickup doesn't materialize, the earnings potential won't be there.

The second half pickup, if it comes along as I expect it to, may also mark the end of the decline in long-term interest rates. Taking 8.50 percent as a possible bond rate in early 1987, and S&P earnings estimates of \$17.25 this year and about \$19 for 1987 (up 10 percent in a strong-growth environment), equity prices on this basis appear to be a bit full despite strong profits growth. That's the intermediate term view of the market.

Now, there's another approach to the markets that may appear to border on the technical but, in fact, does have its foundations in economic logic. I refer here to the Presidential

economic cycle. Presidents, particularly Republican Presidents, tend to do different things at different stages of their terms, with pronounced results for the stock market.

A look at the postwar record for Presidential terms shows that we always have a recession in the first half of a Republican's term and it has been that way with all Republicans back to and including Herbert Hoover. Under Democrats, you never get a recession in the first half of the term. Now, there are several ways to interpret this but, at least from a Republican standpoint, one interpretation might be that the Democrats get to throw all the parties and the Republicans have to clean the house and do the dishes afterwards.

Curiously enough, however, under either Republicans or Democrats, the stock market tends to do virtually nothing in the first half of a President's term. Of course, within that two-year period there can be tremendous volatility so that, if you're in the market, you would hardly characterize the market as "doing nothing." But that's the way it works out over the full two-year period. Now, if past is prologue, what does that mean for the near-term market outlook? Well, the S&P 500 index is now 235-240. In order for it to be where it's supposed to be by the fourth quarter of this year—that is, in order to make it virtually flat versus two years ago (1984 fourth quarter = 165), the market will have to fall quite a lot between now and then. Wow! Let's hope that, in this case, past is not prologue. Is it?

President Reagan appears likely to break the pattern of recessions in the first half of all Republican Administrations. Interesting! Do you suppose it's because his policy actions, particularly the huge budget deficits, are more like those of a Democrat, or what? So much for the first half of a President's term. What about the second half? Curiously, from the midpoint on, it hasn't seemed to make much difference which party was in the White House. We tend to get some solid gains in the economy from either party and we never have recessions—well, almost never.

Regardless of party, the market tends to go up 32 percent in the second half. To show how representative that number is, six out of eight times in post-World War II history, the gain was in the range of 30 to 48 percent. In 1960—when the Republicans made the fatal mistake of having a recession in the second half of the term—the market did not produce the requisite result. (It was up only 6 percent.) Again, in the second half of Reagan's first term, the market rose only about 20 percent but two months later, in February, 1985, it was up exactly 32 percent from the fourth quarter of 1982.

So, from this point of view as well, the market appears a bit overblown relative to past history. But that's because we've always had a recession right about now in a Republican administration. I don't think we're headed for a recession any time soon. If not, then we will have made it through the toughest period for the equity markets relative to the Presidential economic cycle. After the end of this year, as policy begins to focus intensively on the 1988 elections, the risks for the market will be markedly lower. One might almost say it's now or never for market weakness; that is, if we don't get a market

correction in the next 6-9 months, chances are we won't have one through 1988.

Stringing these three views together, I'd say there's a little upside left while oil prices continue to plumb for a bottom

but, thereafter, economic fundamentals suggest that equity prices may be a bit spongy through early 1987. Beyond that, things look very promising for the equity markets—if past is prologue. Ah, there's the rub.

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